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TECHNICAL CORRECTIONS ACT OF 1985; AND TECHNICAL CORRECTIONS TO THE RETIREMENT EQUITY ACT OF 1984

HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

NINETY-NINTH CONGRESS

FIRST SESSION

ON

H.R. 1800

TO MAKE TECHNICAL CORRECTIONS TO THE TAX REFORM ACT OF 1984, AND FOR OTHER PURPOSES

AND

H.R. 2110

TO MAKE TECHNICAL CORRECTIONS RELATED TO THE RETIREMENT EQUITY ACT OF 1984

MAY 16, 1985

Serial 99-29

Printed for the use of the Committee on Ways and Means

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TECHNICAL CORRECTIONS ACT OF 1985; AND TECHNICAL CORRECTIONS TO THE RETIREMENT EQUITY ACT OF 1984

THURSDAY, MAY 16, 1985

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, DC.

The committee met, pursuant to call, at 10 a.m., in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

[The press release announcing the hearing and copies of the bills, H.R. 1800 and H.R. 2110, follow. Testimony begins at p. 252.]

[For immediate release, Monday, April 22, 1985]

THE HONORABLE DAN ROSTENKOWSKI (D., ILL.), CHAIRMAN, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES HEARINGS ON H.R. 1800, THE TECHNICAL CORRECTIONS ACT OF 1985, AND H.R. 2110, MAKING TECHNICAL CORRECTIONS TO THE RETIREMENT EQUITY ACT OF 1984

The Honorable Dan Rostenkowski (D., Ill.), Chairman of the Committee on Ways and Means, U.S. House of Representatives, today announced that the Committee will hold a public hearing on H.R. 1800 (Mr. Rostenkowski, Mr. Duncan), the Technical Corrections Act of 1985, and H.R. 2110 (Mr. Rostenkowski, Mr. Duncan, Mr. Clay and Mrs. Roukema), a bill making technical corrections to the Retirement Equity Act of 1984. The hearing will be held on Thursday, May 16, 1985, beginning at 10:00 a.m. in the Committee's main hearing room, 1100 Longworth House Office Building.

H.R. 1800 would make technical corrections to the Deficit Reduction Act of 1984 (Public Law 98-369) and certain other recently enacted legislation. H.R. 2110 makes technical corrections to the Retirement Equity Act of 1984 (Public Law 98-397).

In announcing the hearing, Chairman Rostenkowski encourages all those who have an interest in the legislation either to appear personally or provide written statements for the record. It is hoped that individuals aware of additional technical problems not addressed in the bill will bring them to the Committee's attention. The Chairman also reemphasizes his statement made at the time of introduction that this legislation not become a vehicle for substantive changes: "A high definitional standard will apply to each proposed 'technical' amendment, and advocates of additional changes will be expected to carry that burden."

A full description of H.R. 1800 is provided in a Joint Committee pamphlet issued on April 4, 1985 (JCS-7-85). A description of H.R. 2110 is contained in the Congressional Record of April 18, 1985, at page E 1583.

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD

Individuals and organizations interested in presenting oral testimony before the Committee must submit their requests to be heard in writing no later than Wednesday, May 8, 1985, to Joseph K. Dowley, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. Notification to those scheduled to appear will be made by telephone as soon as possible after the filing deadline.

It is urged that persons and organizations having a common position make every effort to designate one spokesman to represent them in order for the Committee to hear as many points of view as possible. Time for oral presentations will be strictly limited with the understanding that a more detailed statement may be included in the printed record of the hearing. This process will afford more time for members to question witnesses. In addition, witnesses may be grouped as panelists with strict time limitations for each panelist.

In order to assure the most productive use of the limited amount of time available to question hearing witnesses, all witnesses scheduled to appear before the Committee are required to submit 200 copies of their prepared statements to the Committee office, room 1102 Longworth House Office Building, at least 24 hours in advance of their scheduled appearances. Failure to comply with this requirement may result in the witness being denied the opportunity to testify in person.

Requests to be heard, prepared statements to be presented in person, and statements filed for the printed record of the hearing, must contain the following information:

1. The name, full address, and capacity in which the witness will appear, as well as a telephone number where the witness or a designated representative may be reached;
2. A list of any clients or persons, or any organization for whom the witness appears; and
3. A topical outline or summary of comments and recommendations.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE

Persons submitting written statements for the printed record of the hearing should submit at least six (6) copies by the close of business, Wednesday, May 29, 1985, to Joseph K. Dowley, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. (See other requirements enumerated above.) If those filing written statements for the record of the printed hearing wish to have their statements distributed to the press and the interested public, they may provide 100 additional copies for this purpose to the Committee office before the hearing begins.

99TH CONGRESS
1ST SESSION

H. R. 1800

To make technical corrections relating to the Tax Reform Act of 1984, and for other purposes.

IN THE HOUSE OF REPRESENTATIVES

MARCH 28, 1985

Mr. ROSTENKOWSKI (for himself and Mr. DUNCAN) introduced the following bill; which was referred to the Committee on Ways and Means

---

A BILL

To make technical corrections relating to the Tax Reform Act of 1984, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Technical Corrections Act of 1985".

TITLE I—TECHNICAL CORRECTIONS RELATED TO TAX REFORM ACT OF 1984

SEC. 100. AMENDMENT OF 1954 CODE.

Except as otherwise expressly provided, whenever in this title an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1954.

PART A—AMENDMENTS RELATED TO TITLE I OF THE ACT

SEC. 101. AMENDMENTS RELATED TO DEFERRAL OF CERTAIN TAX REDUCTIONS.

(a) AMENDMENT RELATED TO SECTION 26 OF THE ACT.—Paragraph (2) of section 4251(b) (relating to rate of tax on communications services) is amended by inserting "1985," after "1984," in the table contained in such section.

(b) AMENDMENTS RELATED TO SECTION 27 OF THE ACT.—

(1) Subsection (e) of section 5061 (relating to payment by electronic fund transfer of alcohol taxes) is amended by adding at the end thereof the following new paragraph:

"(3) CONTROLLED GROUPS.—

"(A) IN GENERAL.—In the case of a controlled group of corporations, all corporations which are component members of such group shall be treated as 1 taxpayer. For purposes of the preceding sentence, the term 'controlled group of corporations' has the meaning given to such term by subsection (a) of section 1563, except that 'more than 50 percent' shall be substituted for 'at least 80 percent' each place it appears in such subsection.

"(B) CONTROLLED GROUPS WHICH INCLUDE NONINCORPORATED PERSONS.—Under regulations prescribed by the Secretary, principles similar to the principles of subparagraph (A) shall apply to a group of persons under common control where 1 or more of such persons is not a corporation."

(2) Paragraph (3) of section 5703(b) (relating to payment by electronic fund transfer of tobacco taxes) is amended by adding at the end thereof the following: "Rules similar to the rules of section 5061(e)(3) shall apply to the $5,000,000 amount specified in the preceding sentence."

SEC. 102. AMENDMENTS RELATED TO TAX-EXEMPT ENTITY LEASING PROVISIONS.

(a) AMENDMENTS RELATING TO SECTION 31 OF THE ACT.—

(1) TREATMENT OF USE IN UNRELATED TRADE OR BUSINESS.—Subparagraph (D) of section 168(j)(3) (relating to exception where property used in unrelated trade or business) is amended by adding at the end thereof the following new sentence: "For purposes of subparagraph (B)(iii), any portion of a property so used shall not be treated as leased to a tax-exempt entity in a disqualified lease."

(2) TREATMENT OF CERTAIN PREVIOUSLY TAX-EXEMPT ORGANIZATIONS.—

(A) Clause (i) of section 168(j)(4)(E) (relating to treatment of certain previously tax-exempt organizations) is amended—

(i) by striking out "any property of which such organization is the lessee" and inserting in lieu thereof "any property (other than property held by such organization)", and

(ii) by striking out "first leased to" and inserting in lieu thereof "first used by".

(B) Subclause (I) of section 168(j)(4)(E)(ii) is amended by striking out "of which such organization is the lessee".

(C) Subclause (II) of section 168(j)(4)(E)(ii) is amended by striking out "is placed in service under the lease" and inserting in lieu thereof "is first used by the organization".

(D) Subparagraph (E) of section 168(j)(4) is amended by adding at the end thereof the following new clause:

"(iv) FIRST USED.—For purposes of this subparagraph, property shall be treated as first used by the organization—

"(I) when the property is first placed in service under a lease to such organization, or

"(II) in the case of property leased to (or held by) a partnership (or other pass-thru entity) in which the organization is a member, the later of when such property is first used by such partnership or pass-thru entity or when such organization is first a member of such partnership or pass-thru entity."

(E) Clause (i)(I) of section 31(g)(16)(C) of the Tax Reform Act of 1984 (defining exempt arbitrage profits) is amended by striking out "section 168(j)(4)(E)(i)(I)" and inserting in lieu thereof "section 168(j)(4)(E)(i)".

(3) REPEAL OF OVERLAPPING SECRETARIAL AUTHORITY.—Clause (iv) of section 168(j)(5)(C) (relating to property not subject to rapid obsolescence may be excluded) is hereby repealed.

(4) PARTNERSHIP RULES.—

(A) Paragraph (8) of section 168(j) (relating to tax-exempt use of property leased to partnerships, etc., determined at partner level) is amended by striking out "and paragraphs (4) and (5) of section 48(a)" in the matter preceding subparagraph (A).

(B) Paragraph (9) of section 168(j) (relating to treatment of property owned by partnerships, etc.) is amended—

(i) by striking out "and paragraphs (4) and (5) of section 48(a)" in subparagraph (A), and

(ii) by striking out "loss deduction" in subparagraph (B)(i) and inserting in lieu thereof "loss, deduction".

(C) Paragraph (5) of section 48(a) (relating to property used by governmental units or foreign persons or entities) is amended by redesignating subparagraph (D) as subparagraph (E) and by inserting after subparagraph (C) the following new subparagraph:

"(D) SPECIAL RULES FOR PARTNERSHIPS, ETC.—For purposes of this paragraph and paragraph (4), rules similar to the rules of paragraphs (8) and (9) of section 168(j) shall apply."

(5) TREATMENT OF CERTAIN AIRCRAFT LEASED TO FOREIGN PERSONS.—

(A) Subsection (a) of section 47 (relating to certain dispositions, etc., of section 38 property) is amended by adding at the end thereof the following new paragraph:

"(9) AIRCRAFT LEASED TO FOREIGN PERSONS OR ENTITIES.—

"(A) IN GENERAL.—Any aircraft which was new section 38 property for the taxable year in which it was placed in service and which is used by any foreign person or entity (as defined in section 168(j)(4)(C)) under a qualified lease (as defined in paragraph (7)(C)) entered into before January 1, 1990, shall not be treated as ceasing to

be section 38 property by reason of such use until such aircraft has been so used for a period or periods exceeding 3 years in total.

"(B) RECAPTURE PERIOD EXTENDED.—For purposes of paragraphs (1) and (5)(B) of this subsection, any period during which there was use described in subparagraph (A) of an aircraft shall be disregarded."

(B) Clause (iii) of section 48(a)(5)(B) is hereby repealed.

(6) TREATMENT OF CERTAIN PARTNERSHIPS HAVING SECTION 593 ORGANIZATION AS MEMBER.—Paragraph (4) of section 46(e) is amended by adding at the end thereof the following new subparagraph:

"(D) SPECIAL RULES FOR PARTNERSHIPS, ETC.—For purposes of paragraph (1)(A), rules similar to the rules of paragraphs (8) and (9) of section 168(j) shall apply."

(7) TREATMENT OF CERTAIN PROPERTY HELD BY PARTNERSHIPS.—

(A) Paragraph (9) of section 168(j) (relating to treatment of property owned by partnerships, etc.) is amended by redesignating subparagraphs (D) and (E) as subparagraphs (E) and (F), respec-

tively, and by inserting after subparagraph (C) the following new subparagraph:

"(D) DETERMINATION OF WHETHER PROPERTY USED IN UNRELATED TRADE OR BUSINESS.—For purposes of this subsection, in the case of any property which is owned by a partnership which has both a tax-exempt entity and a person who is not a tax-exempt entity as partners, the determination of whether such property is used in an unrelated trade or business of such an entity shall be made without regard to section 514."

(B) Subparagraph (E) of section 168(j)(9) (as redesignated by subparagraph (A)) is amended by striking out "and (C)" and inserting in lieu thereof "(C), and (D)".

(8) CLERICAL AMENDMENTS.—

(A) Paragraph (4) of section 48(a) is amended—

(i) by striking out "514(c)" and inserting in lieu thereof "514(b)", and

(ii) by striking out "514(b)" and inserting in lieu thereof "514(a)".

(B) Subclause (I) of section 48(g)(2)(B)(vi) is amended by striking out "section 168(j)(3)" and inserting in lieu thereof "section 168(j)".

(C) Subparagraph (A) of section 7701(e)(4) is amended by adding at the end thereof the following new sentence:

"For purposes of this paragraph, the term 'related entity' has the same meaning as when used in section 168(j)."

(9) EFFECTIVE DATE PROVISIONS.—

(A) Subparagraph (B) of section 31(g)(3) of the Tax Reform Act of 1984 is amended by striking out "The amendments made by this section" and inserting in lieu thereof "Paragraph (9) of section 168(j) of the Internal Revenue Code of 1954 (as added by this section)".

(B) Clause (ii) of section 31(g)(15)(D) of the Tax Reform Act of 1984 (relating to certain aircraft) is amended to read as follows:

"(ii) such aircraft is originally placed in service by such foreign person or entity (or its successor in interest under the contract) after May 23, 1983, and before January 1, 1986."

(C) Paragraph (4) of section 31(g) of the Tax Reform Act of 1984 is amended by adding at the end thereof the following new subparagraph:

"(C) SPECIAL RULE FOR CREDIT UNIONS.—In the case of any property leased to a credit union pursuant to a written binding contract with an expiration date of December 31, 1984, which was entered into by such organization on August 23, 1984—

"(i) such credit union shall not be treated as an agency or instrumentality of the United States; and

"(ii) clause (ii) of subparagraph (A) shall be applied by substituting 'January 1, 1987' for 'January 1, 1985'."

(D)(i) Clause (ii) of section 31(g)(20)(B) of the Tax Reform Act of 1984 (defining substantial improvement) is amended by striking out subclauses (I) and (II) and inserting in lieu thereof the following:

"(I) by substituting 'property' for 'building' each place it appears therein,

"(II) by substituting '20 percent' for '25 percent' in clause (ii) thereof, and

"(III) without regard to clause (iii) thereof."

(ii) The amendment made by clause (i) shall not apply to any property if—

(I) on or before March 28, 1985, the taxpayer (or a predecessor in interest under the contract) or the tax-exempt entity entered into a written binding contract to acquire, construct, or rehabilitate the property, or

(II) the taxpayer or the tax-exempt entity began the construction, reconstruction, or rehabilitation of the property on or before March 28, 1985.

(b) AMENDMENTS RELATED TO SECTION 32 OF THE ACT.—

(1) Subsection (f) of section 168 (relating to special rules) is amended—

(A) by redesignating the paragraph (13) relating to motor vehicle operating leases as paragraph (14), and

(B) by redesignating paragraph (14) as paragraph (15).

(2) Subsection (c) of section 32 of the Tax Reform Act of 1984 is amended by striking out "section

168(f)(13)" and inserting in lieu thereof "section 168(i)(14)".

SEC. 103. AMENDMENTS RELATED TO TREATMENT OF BONDS AND OTHER DEBT INSTRUMENTS.

(a) AMENDMENTS RELATED TO SECTION 41 OF THE ACT.—

(1) TREATMENT OF SHORT-TERM NONGOVERNMENT OBLIGATIONS.—

(A) Subsection (a) of section 1271 (relating to treatment of amounts received on retirement or sale or exchange of debt instruments) is amended by adding at the end thereof the following new paragraph:

"(4) CERTAIN SHORT-TERM NONGOVERNMENT OBLIGATIONS.—

"(A) IN GENERAL.—On the sale or exchange of any short-term nongovernment obligation, any gain realized which does not exceed an amount equal to the ratable share of the original issue discount shall be treated as ordinary income.

"(B) SHORT-TERM NONGOVERNMENT OBLIGATION.—For purposes of this paragraph, the term 'short-term nongovernment obligation' means any obligation which—

"(i) has a fixed maturity date not more than 1 year from the date of the issue, and

"(ii) is not a short-term Government obligation (as defined in paragraph (3)(B) without regard to the last sentence thereof).

"(C) RATABLE SHARE.—For purposes of this paragraph, except as provided in subparagraph (D), the ratable share of the original issue discount is an amount which bears the same ratio to such discount as—

"(i) the number of days which the taxpayer held the obligation, bears to

"(ii) the number of days after the date of original issue and up to (and including) the date of its maturity.

"(D) ELECTION OF ACCRUAL ON BASIS OF CONSTANT INTEREST RATE.—At the election of the taxpayer with respect to any obligation, the ratable share of the original issue discount is the portion of the original issue discount accruing while the taxpayer held the obligation determined (under regulations prescribed by the Secretary) on the basis of—

"(i) the yield to maturity based on the issue price of the obligation, and

"(ii) compounding daily.

Any election under this subparagraph, once made with respect to any obligation, shall be irrevocable."

(B) Paragraph (3) of section 1283(d) is amended by striking out "section 1271(a)(3)" and inserting in lieu thereof "paragraphs (3) and (4) of section 1271(a)".

(2) ELECTION OF ACCRUAL ON BASIS OF CONSTANT INTEREST RATE FOR SHORT-TERM GOVERNMENT OBLIGATIONS.—

(A) IN GENERAL.—Paragraph (3) of section 1271(a) (relating to certain short-term Government obligations) is amended by adding at the end thereof the following new subparagraph:

"(E) ELECTION OF ACCRUAL ON BASIS OF CONSTANT INTEREST RATE.—At the election of the taxpayer with respect to any obligation, the ratable share of the acquisition discount is the portion of the acquisition discount accruing while the taxpayer held the obligation determined (under regulations prescribed by the Secretary) on the basis of—

"(i) the taxpayer's yield to maturity based on the taxpayer's cost of acquiring the obligation, and

"(ii) compounding daily.

An election under this subparagraph, once made with respect to any obligation, shall be irrevocable."

(B) TECHNICAL AMENDMENT.—Subparagraph (D) of section 1271(a)(3) is amended by striking out "this paragraph" and inserting in lieu thereof "this paragraph, except as provided in subparagraph (E),".

(3) DEFINITION OF SHORT-TERM GOVERNMENT OBLIGATION.—Subparagraph (B) of section 1271(a)(3) (defining short-term Government obligation) is amended to read as follows:

"(B) SHORT-TERM GOVERNMENT OBLIGATION.—For purposes of this paragraph, the term 'short-term Government obligation' means any obligation of the United States or any of its possessions, or of a State or any political subdivision thereof, or of the District of Columbia, which has a fixed maturity date not more than 1 year from the date of issue. Such term does not include any tax-exempt obligation."

(4) DEDUCTION OF ORIGINAL ISSUE DISCOUNT ON SHORT-TERM OBLIGATIONS.—Paragraph (2) of section 163(e) (relating to original issue discount) is amended by adding at the end thereof the following new subparagraph:

"(C) SHORT-TERM OBLIGATIONS.—In the case of an obligor of a short-term obligation (as defined in section 1283(a)(1)(A)) who uses the cash receipts and disbursements method of accounting, the original issue discount (and any other interest payable) on such obligation shall be deductible only when paid."

(5) TREATMENT OF CERTAIN TRANSFERS OF MARKET DISCOUNT BONDS.—Paragraph (1) of section 1276(d) (relating to special rules) is amended by striking out "and" at the end of subparagraph (A) and by inserting after subparagraph (B) the following new subparagraph:

"(C) paragraph (3) of section 1245(b) shall be applied as if it did not contain a reference to section 351, and".

(6) TREATMENT OF BONDS ACQUIRED AT ORIGINAL ISSUE FOR PURPOSES OF MARKET DISCOUNT RULES.—

(A) Paragraph (1) of section 1278(a) (defining market discount bond) is amended by adding at the end thereof the following new subparagraph:

"(C) TREATMENT OF BONDS ACQUIRED ON ORIGINAL ISSUE.—

"(i) IN GENERAL.—Except as otherwise provided in this subparagraph or in regulations, the term 'market discount bond' shall not include any bond acquired by the taxpayer at its original issue.

"(ii) TREATMENT OF BONDS ACQUIRED FOR LESS THAN ISSUE PRICE.—Clause (i) shall not apply to any bond if—

"(I) the basis of the taxpayer in such bond is determined under section 1012, and

"(II) such basis is less than the issue price of such bond determined under subpart A of this part.

"(iii) BONDS ACQUIRED IN CERTAIN REORGANIZATIONS.—Clause (i) shall not apply to any bond issued pursuant to a plan of reorganization (within the meaning of section 368(a)(1)) in exchange for another bond having market discount. Solely for purposes

of section 1276, the preceding sentence shall not apply if such other bond was issued on or before July 18, 1984 (the date of the enactment of section 1276) and if the bond issued pursuant to such plan of reorganization has the same term and the same interest rate as such other bond had.

"(iv) TREATMENT OF CERTAIN TRANSFERRED BASIS PROPERTY.—For purposes of clause (i), if the adjusted basis of any bond in the hands of the taxpayer is determined by reference to the adjusted basis of such bond in the hands of a person who acquired such bond at its original issue, such bond shall be treated as acquired by the taxpayer at its original issue."

(7) TREATMENT OF CERTAIN STRIPPED BONDS OR STRIPPED COUPONS.—Paragraph (1) of section 1281(b) (relating to short-term obligations to which section applies) is amended by striking out "or" at the end of subparagraph (D), by striking out the period at the end of subparagraph (E) and inserting in lieu thereof ", or", and by adding at the end thereof the following new subparagraph:

"(F) is a stripped bond or stripped coupon held by the person who stripped the bond or coupon (or by any other person whose basis is determined by reference to the basis in the hands of such person)."

(8) ACCRUAL OF INTEREST PAYMENTS ON CERTAIN SHORT-TERM OBLIGATIONS.—

(A) Subsection (a) of section 1281 (relating to current inclusion in income of discount on certain short-term obligations) is amended to read as follows:

"(a) GENERAL RULE.—In the case of any short-term obligation to which this section applies, for purposes of this title—

"(1) there shall be included in the gross income of the holder an amount equal to the sum of the daily portions of the acquisition discount for each day during the taxable year on which such holder held such obligation, and

"(2) any interest payable on the obligation (other than interest taken into account in determining the amount of the acquisition discount) shall be included in gross income as it accrues."

(B) Subsection (a) of section 1282 (relating to deferral of interest deduction allocable to accrued discount) is amended to read as follows:

"(a) GENERAL RULE.—Except as otherwise provided in this section, the net direct interest expense with respect to any short-term obligation shall be allowed as a deduction for the taxable year only to the extent such expense exceeds the sum of—

"(1) the daily portions of the acquisition discount for each day during the taxable year on which the taxpayer held such obligation, and

"(2) the amount of any interest payable on the obligation (other than interest taken into account in determining the amount of the acquisition discount) which accrues during the taxable year while the taxpayer held such obligation (and is not included in the gross income of the taxpayer for such taxable year by reason of the taxpayer's method of accounting)."

(9) TREATMENT OF TRANSFERS OF LAND BETWEEN RELATED PARTIES.—Paragraph (1) of section 483(f) (relating to maximum rate of interest on certain transfers of land between related parties) is amended to read as follows:

"(1) IN GENERAL.—In the case of any qualified sale, the discount rate used—

"(A) for purposes of subsection (b), shall not exceed 7 percent, compounded semiannually, and

"(B) for purposes of subsection (c)(1), shall not exceed 6 percent, compounded semiannually."

(10) CLARIFICATION OF TREATMENT OF DEBT INSTRUMENTS ISSUED FOR PUBLICLY TRADED PROPERTY.—

(A) Subparagraph (B) of section 1273(b)(3) (relating to debt instruments issued for property where there is public trading) is amended to read as follows:

"(B)(i) is issued for stock or securities which are traded on an established securities market, or

"(ii) to the extent provided in regulations, is issued for property (other than stock or securities) of a kind regularly traded on an established market,".

(B) Paragraph (3) of section 1273(b) is amended by striking out "the fair market value of such property" and inserting in lieu thereof "the fair market value of such property (as of the first day on which a substantial portion of the debt instruments was issued)".

(11) CLERICAL AMENDMENTS.—

(A) Subparagraph (A) of section 1274(c)(4) is amended by striking out "FOR LESS THAN $1,000,000" in the subparagraph heading and inserting in lieu thereof "FOR $1,000,000 OR LESS".

(B) Subparagraph (F) of section 1274(c)(4) is amended by striking out "section 483(e)" each place it appears and inserting in lieu thereof "section 483(f)".

(C) Paragraph (1) of section 483(d) is amended by striking out "any debt instrument to which section 1272 applies" and inserting in lieu thereof "any debt instrument for which an issue price is determined under section 1273(b) (other than paragraph (4) thereof) or section 1274".

(D) Clause (iii) of section 6049(b)(5)(B) is amended by striking out "section 1232(b)(1)" and inserting in lieu thereof "section 1273(a)".

(b) AMENDMENTS RELATED TO SECTION 44 OF THE ACT.—

(1) CLARIFICATION OF TRANSITIONAL RULE FOR PURPOSES OF IMPUTED INTEREST RULES.—Paragraph (4) of section 44(b) of the Tax Reform Act of 1984 (relating to special rules for sales before July 1,

1985), as added by section 2 of Public Law 98-612, is amended—

(A) by striking out "before July 1, 1985" in subparagraph (A) and inserting in lieu thereof "after December 31, 1984, and before July 1, 1985",

(B) by striking out "BEFORE JULY 1, 1985" in the paragraph heading and inserting in lieu thereof "AFTER DECEMBER 31, 1984, AND BEFORE JULY 1, 1985", and

(C) by adding at the end thereof the following new subparagraph:

"(G) CLARIFICATION OF APPLICATION OF THIS PARAGRAPH, ETC.—This paragraph and paragraphs (5), (6), and (7) shall apply only in the case of sales or exchanges to which section 1274 or 483 of the Internal Revenue Code of 1954 (as amended by section 41) applies."

(2) CLARIFICATION OF INTEREST ACCRUAL, ETC.—Subparagraph (A) of section 44(b)(3) of the Tax Reform Act of 1984 is amended by striking out "and before January 1, 1985," each place it appears.

(3) EXCEPTION FOR BINDING CONTRACTS.—Subparagraph (B) of section 44(b)(3) of the Tax Reform Act of 1984 is amended to read as follows:

"(B) EXCEPTION FOR BINDING CONTRACTS.—

"(i) Subparagraph (A)(i)(I) shall not apply to any sale or exchange pursuant to a written contract which was binding on March 1, 1984, and at all times thereafter before the sale or exchange.

"(ii) Subparagraph (A)(i)(II) shall not apply to any sale or exchange pursuant to a written contract which was binding on June 8, 1984, and at all times thereafter before the sale or exchange."

(4) CLERICAL AMENDMENT.—Clause (ii) of section 44(b)(6)(B) of the Tax Reform Act of 1984 (as added by section 2 of Public Law 98-612) is amended by striking out "greater than" and inserting in lieu thereof "not greater than".

SEC. 104. AMENDMENTS RELATED TO CORPORATE PROVISIONS.

(a) AMENDMENT RELATED TO SECTION 51 OF THE ACT.—Subsection (a) of section 246A (relating to dividends received deduction reduced where portfolio stock is debt financed) is amended—

(1) by striking out "or 245" and inserting in lieu thereof "or 245(a)", and

(2) by adding at the end thereof the following new sentence:

"The preceding sentence shall be applied before any determination of a ratio under paragraph (1) or (2) of section 245(a)."

(b) AMENDMENTS RELATED TO SECTION 53 OF THE ACT.—

(1) AMENDMENTS OF SECTION 246.—

(A) Subparagraph (A) of section 246(c)(1) (relating to exclusion of certain dividends) is amended to read as follows:

"(A) which is held by the taxpayer for 45 days or less, or".

(B) Paragraph (4) of section 246(c) (relating to holding period reduced for periods where risk of loss diminished) is amended by striking out "determined under paragraph (3)" and inserting in lieu thereof "determined for purposes of this subsection".

(2) EFFECTIVE DATE FOR RELATED PERSON PROVISIONS.—Paragraph (3) of section 53(e) of the Tax Reform Act of 1984 (relating to effective date for related person provisions) is amended to read as follows:

"(3) RELATED PERSON PROVISIONS.—

"(A) IN GENERAL.—Except as otherwise provided in subparagraph (B), the amendment made by subsection (c) shall take effect on July 18, 1984.

"(B) SPECIAL RULE FOR PURPOSES OF SECTION 265(2).—The amendment made by subsection (c) insofar as it relates to section 265(2) of the Internal Revenue Code of 1954 shall apply to—

"(i) term loans made after July 18, 1984, and

"(ii) demand loans outstanding after July 18, 1984 (other than any loan outstanding on July 18, 1984, and repaid before September 18, 1984).

"(C) TREATMENT OF RENEGOTIATIONS, ETC.—For purposes of this paragraph, any loan renegotiated, extended, or revised after July 18, 1984, shall be treated as a loan made after such date.

"(D) DEFINITION OF TERM AND DEMAND LOANS.—For purposes of this paragraph, the terms 'demand loan' and 'term loan' have the respective meanings given such terms by paragraphs (5) and (6) of section 7872(f) of the Inter-

nal Revenue Code of 1954, except that the second sentence of such paragraph (5) shall not apply."

(c) AMENDMENTS RELATED TO SECTION 55 OF THE ACT.—

(1) Clause (ii) of section 852(b)(4)(B) (relating to losses attributable to exempt-interest dividend) is amended by striking out "for less than 31 days" and inserting in lieu thereof "for 6 months or less".

(2) Subparagraph (C) of section 852(b)(4) (relating to determination of holding periods) is amended to read as follows:

"(C) DETERMINATION OF HOLDING PERIODS.—For purposes of this paragraph, the rules of paragraphs (3) and (4) of section 246(c) shall apply in determining the period for which the taxpayer has held any share of stock; except that '6 months' shall be substituted for each number of days specified in subparagraph (B) of section 246(c)(3)."

(3) Subparagraph (D) of section 852(b)(4) (relating to losses incurred under a periodic liquidation plan) is amended by striking out "subparagraph (A)" and inserting in lieu thereof "subparagraphs (A) and (B)".

(4) The paragraph heading for paragraph (4) of section 852(b) is amended by striking out "LESS THAN 31 DAYS" and inserting in lieu thereof "6 MONTHS OR LESS".

(5) The amendments made by this subsection shall apply to stock with respect to which the taxpayer's holding period begins after March 28, 1985.

(d) AMENDMENTS RELATED TO SECTION 60 OF THE ACT.—

(1) TREATMENT OF CERTAIN REDEMPTION AND LIQUIDATION RIGHTS.—Subparagraph (C) of section 1504(a)(4) (relating to certain preferred stock not treated as stock) is amended to read as follows:

"(C) has redemption and liquidation rights which do not exceed the issue price of such stock (except for a reasonable redemption or liquidation premium), and".

(2) TREATMENT OF CERTAIN CORPORATIONS AFFILIATED ON JUNE 22, 1984.—Paragraph (2) of section 60(b) of the Tax Reform Act of 1984 (relating to special rule for corporations affiliated on June 22, 1984) is amended by adding at the end thereof the following new sentence: "The preceding sentence shall cease to apply as of the first day after June 22, 1984, on which such corporation does not qualify as a

member of such group under section 1504(a) of the Internal Revenue Code of 1954 (as in effect on the day before the date of the enactment of this Act)."

(3) TREATMENT OF CERTAIN SELL-DOWNS AFTER JUNE 22, 1984.—Paragraph (3) of section 60(b) of the Tax Reform Act of 1984 (relating to special rule not to apply to certain sell-downs after June 22, 1984) is amended to read as follows:

"(3) SPECIAL RULE NOT TO APPLY TO CERTAIN SELL-DOWNS AFTER JUNE 22, 1984.—If—

"(A) the requirements of paragraph (2) are satisfied with respect to a corporation,

"(B) more than a de minimis amount of the stock of such corporation—

"(i) is sold or exchanged (including in a redemption), or

"(ii) is issued,

after June 22, 1984 (other than in the ordinary course of business), and

"(C) the requirements of the amendment made by subsection (a) are not satisfied after such sale, exchange, or issuance,

then the amendment made by subsection (a) shall apply for purposes of determining whether such corporation continues to be a member of the group. The preceding

sentence shall not apply to any transaction if such transaction does not reduce the percentage of the fair market value of the stock of the corporation referred to in the preceding sentence held by members of the group determined without regard to this paragraph."

(4) AMENDMENT OF SECTION 332.—

(A) IN GENERAL.—Paragraph (1) of section 332(b) (relating to liquidations to which section applies) is amended to read as follows:

"(1) the corporation receiving such property was, on the date of the adoption of the plan of liquidation, and has continued to be at all times until the receipt of the property, the owner of stock (in such other corporation) meeting the requirements of section 1504(a)(2); and either".

(B) EFFECTIVE DATE.—

(i) IN GENERAL.—Except as provided in clause (iii), the amendment made by subparagraph (A) shall apply with respect to plans of complete liquidation adopted after March 28, 1985.

(ii) CERTAIN DISTRIBUTIONS MADE AFTER DECEMBER 31, 1984.—Except as provided in clause (iii), the amendment made by subparagraph (A) shall also apply with re-

spect to plans of complete liquidations adopted on or before March 28, 1985, pursuant to which any distribution is made in a taxable year beginning after December 31, 1984, but only if the liquidating corporation and any corporation which receives a distribution in complete liquidation of such corporation are members of an affiliated group of corporations filing a consolidated return for the taxable year which includes the date of the distribution.

(iii) TRANSITIONAL RULE FOR AFFILIATED GROUPS.—The amendment made by subparagraph (A) shall not apply with respect to plans of complete liquidation if the liquidating corporation is a member of an affiliated group of corporations under section 60(b)(2) or (5) of the Tax Reform Act of 1984, for all taxable years which include the date of any distribution pursuant to such plan.

(5) AMENDMENT OF SECTION 337.—

(A) IN GENERAL.—Subparagraph (B) of section 337(c)(3) (defining distributee corporation) is amended to read as foilows:

"(B) DISTRIBUTEE CORPORATION.—For purposes of subparagraph (A), the term 'distributee corporation' means any corporation which receives a distribution to which section 332 applies in a complete liquidation of the selling corporation. Such term also includes any other corporation which receives a distribution to which section 332 applies in a complete liquidation of a corporation which is a distributee corporation under the preceding sentence or prior application of this sentence."

(B) EFFECTIVE DATE.—The amendment made by subparagraph (A) shall apply in the case of plans of complete liquidation pursuant to which any distribution is made in a taxable year beginning after December 31, 1984.

(6) TREATMENT OF FORMER DISC'S.—Paragraph (7) of section 1504(b) (defining includible corporation) is amended to read as follows:

"(7) A DISC (as defined in section 992(a)(1)) or, to the extent provided in regulations, any other corporation which has accumulated DISC income."

(e) AMENDMENTS RELATED TO SECTION 61 OF THE ACT.—

(1) TREATMENT OF DISTRIBUTIONS OF APPRECIATED PROPERTY.—

(A) Subsection (b) of section 312 (relating to effect on earnings and profits) is amended to read as follows:

"(b) DISTRIBUTIONS OF APPRECIATED PROPERTY.—On the distribution by a corporation, with respect to its stock, of any property the fair market value of which exceeds the adjusted basis thereof, the earnings and profits of the corporation—

"(1) shall be increased by the amount of such excess, and

"(2) shall be decreased by whichever of the following is the lesser:

"(A) the fair market value of the property distributed, or

"(B) the earnings and profits (as increased under paragraph (1))."

(B) Subsection (c) of section 312 is amended by inserting "and" at the end of paragraph (1), by striking out ", and" at the end of paragraph (2) and inserting in lieu thereof a period, and by striking out paragraph (3).

(C) The subsection heading for subsection (c) of section 312 is amended by striking out ", ETC.".

(D) Subsection (n) of section 312 is amended by striking out paragraph (4) and by redesignating paragraphs (5), (6), (7), (8), and (9) as paragraphs (4), (5), (6), (7), and (8), respectively.

(E) Paragraph (8) of section 312(n) (as redesignated by subparagraph (C)) is amended by striking out "paragraphs (5), (6), and (7)" and inserting in lieu thereof "paragraphs (4), (5), and (6)".

(F) Any reference in subsection (e) of section 61 of the Tax Reform Act of 1984 to a paragraph of section 312(n) of the Internal Revenue Code of 1954 shall be treated as a reference to such paragraph as in effect before its redesignation by subparagraph (D).

(2) CLERICAL AMENDMENTS.—

(A) Subsection (a) of section 1275 is amended—

(i) by redesignating the paragraph added by section 61 of the Tax Reform Act of 1984 as paragraph (5), and

(ii) by striking out "TO CORPORATIONS" in the heading of such paragraph and

inserting in lieu thereof "BY CORPORATIONS".

(B) Paragraph (3) of section 301(f) is amended by striking out "this section" and inserting in lieu thereof "this subsection".

(3) EFFECTIVE DATE FOR TREATMENT OF REDEMPTIONS.—Paragraph (7) of section 312(n) of the Internal Revenue Code of 1954 (as redesignated by paragraph (1)(D) of this subsection), and the amendments made by section 61(a)(2) of the Tax Reform Act of 1984, shall apply to distributions after July 18, 1984, in taxable years ending after such date.

(f) AMENDMENTS RELATING TO SECTION 68 OF THE ACT.—

(1) NO DISC PREFERENCE REDUCTION FOR S CORPORATIONS.—Effective with respect to taxable years beginning after December 31, 1982, paragraph (4) of section 291(a) (as in effect on the day before the date of the enactment of the Tax Reform Act of 1984) is amended by striking out "a corporation" and inserting in lieu thereof "a C corporation".

(2) CLARIFICATION OF EFFECTIVE DATES.—

(A) Paragraph (2) of section 68(e) of the Tax Reform Act of 1984 (relating to section 1250 gain) is amended by striking out "of the Internal

Revenue Code of 1954" and inserting in lieu thereof "of the Internal Revenue Code of 1954, and the amendment made by subsection (c)(2) of this section,".

(B) Paragraph (3) of section 68(e) of the Tax Reform Act of 1984 (relating to pollution control facilities) is amended by striking out "of such Code" and inserting in lieu thereof "of such Code, and so much of the amendment made by subsection (c)(1) of this section as relates to pollution control facilities,".

(3) CLERICAL AMENDMENTS.—

(A) The subsection heading of section 291(a) is amended by striking out "20-PERCENT".

(B) Paragraph (2) of section 68(c) of the Tax Reform Act of 1984 is amended by striking out "section 57(h)" and inserting in lieu thereof "section 57(b)".

(C) Subparagraph (B) of section 57(b)(1) is amended to read as follows:

"(B) IRON ORE AND COAL.—In the case of any item of tax preference of a corporation described in paragraph (8) of subsection (a) (but only to the extent such item is allocable to a deduction for depletion for iron ore and coal, including lig-

nite), only 71.6 percent of the amount of such item of tax preference (determined without regard to this subsection) shall be taken into account as an item of tax preference."

(D) Paragraph (2) of section 57(b) is amended by striking out "85 percent" and inserting in lieu thereof "80 percent".

SEC. 105. AMENDMENTS RELATED TO PARTNERSHIP PROVISIONS.

(a) AMENDMENTS RELATED TO SECTION 72 OF THE ACT.—

(1) CLARIFICATION THAT CHANGE NEED NOT OCCUR DURING TAXABLE YEAR OF PAYMENT.—

(A) Clause (i) of section 706(d)(2)(A) is amended by striking out "each such item" and inserting in lieu thereof "such item".

(B) Subparagraph (B) of section 706(d)(2) is amended by striking out "which are described in paragraph (1) and".

(2) CLERICAL AMENDMENT.—Clause (i) of section 706(d)(2)(C) (relating to items attributable to periods not within taxable year) is amended by striking out "the first day of such taxable year" and inserting in lieu thereof "the first day of the taxable year".

(b) AMENDMENT RELATED TO SECTION 73 OF THE ACT.—Clause (iii) of section 707(a)(2)(B) (relating to treatment of certain property transfers) is amended by striking out "sale of property" and inserting in lieu thereof "sale or exchange of property".

(c) AMENDMENT RELATED TO SECTION 75 OF THE ACT.—Subsection (e) of section 761 (relating to distributions treated as exchanges) is amended—

(1) by striking out "any distribution (not otherwise treated as an exchange)" and inserting in lieu thereof "any distribution of an interest in a partnership (not otherwise treated as an exchange)", and

(2) by striking out "DISTRIBUTIONS" in the subsection heading and inserting in lieu thereof "DISTRIBUTIONS OF PARTNERSHIP INTERESTS".

(d) AMENDMENT RELATED TO SECTION 77 OF THE ACT.—Subparagraph (A) of section 1031(a)(3) (relating to requirement that property be identified) is amended by striking out "before the day" and inserting in lieu thereof "on or before the day".

SEC. 106. AMENDMENTS RELATED TO TRUST PROVISIONS.

(a) TREATMENT OF MULTIPLE TRUSTS.—Subsection (b) of section 82 of the Tax Reform Act of 1984 (relating to treatment of multiple trusts) is amended by inserting before the period at the end thereof the following: "; except that, in

the case of a trust which was irrevocable on March 1, 1984, such amendment shall so apply only to that portion of the trust which is attributable to contributions to corpus after March 1, 1984".

(b) CLERICAL AMENDMENTS.—Section 643 (relating to definitions applicable to subparts A, B, C, and D) is amended—

(1) by redesignating the subsection added by section 81 of the Tax Reform Act of 1984 as subsection (e), and

(2) by redesignating the subsection added by section 82 of such Act as subsection (f).

SEC. 107. AMENDMENTS RELATED TO ACCOUNTING CHANGES.

(a) AMENDMENTS RELATED TO SECTION 91 OF THE ACT.—

(1) CLARIFICATION OF CASH BASIS EXCEPTION TO TAX SHELTER RULE.—

(A) Subparagraph (A) of section 461(i)(2) is amended by striking out "within 90 days after the close of the taxable year" and inserting in lieu thereof "before the close of the 90th day after the close of the taxable year".

(B) The heading for paragraph (2) of section 461(i) is amended by striking out "WITHIN 90

DAYS" and inserting in lieu thereof "ON OR BEFORE THE 90TH DAY".

(2) CLARIFICATION OF COORDINATION WITH SECTION 464.—Subparagraph (A) of section 461(i)(4) (relating to special rules for farming) is amended to read as follows:

"(A) any tax shelter described in paragraph (3)(C) shall be treated as a farming syndicate for purposes of section 464; except that this subparagraph shall not apply for purposes of determining the income of an individual meeting the requirements of section 464(c)(2),".

(3) TREATMENT OF MINING AND SOLID WASTE RECLAMATION AND CLOSING COSTS.—

(A) RESERVE INCREASED BY AMOUNT DEDUCTED.—Paragraph (2) of section 468(a) (relating to establishment of reserves for reclamation and closing costs) is amended by adding at the end thereof the following new subparagraph:

"(D) RESERVE INCREASED BY AMOUNT DEDUCTED.—A reserve shall be increased each taxable year by the amount allowable as a deduction under paragraph (1) for such taxable year which is allocable to such reserve."

(B) EFFECTIVE DATE.—Subsection (g) of section 91 of the Tax Reform Act of 1984 (relating to effective dates) is amended by adding at the end thereof the following new paragraph:

"(4) EFFECTIVE DATE FOR TREATMENT OF MINING AND SOLID WASTE RECLAMATION AND CLOSING COSTS.—Except as otherwise provided in subsection (h), the amendments made by subsection (b) shall take effect on the date of the enactment of this Act with respect to taxable years ending after such date."

(C) CLERICAL AMENDMENT.—Paragraph (1) of section 468(a) is amended by striking out "this subsection" and inserting in lieu thereof "this section".

(4) TREATMENT OF DECOMMISSIONING OF NUCLEAR POWERPLANT.—

(A) TIME WHEN PAYMENTS DEEMED MADE.—

(i) IN GENERAL.—Section 468A is amended by adding at the end thereof the following new subsection:

"(g) TIME WHEN PAYMENTS DEEMED MADE.—For purposes of this section, a taxpayer shall be deemed to have made a payment to the Fund on the last day of a taxable year if such payment is made on account of such taxable year and

is made within 2½ months after the close of such taxable year."

(ii) TRANSITIONAL RULE.—To the extent provided in regulations prescribed by the Secretary of the Treasury or his delegate, subsection (g) of section 468A of the Internal Revenue Code of 1954 (as added by clause (i)) shall be applied with respect to any payment on account of a taxable year beginning before January 1, 1985, as if it did not contain the requirement that the payment be made within 2½ months after the close of the taxable year. Such regulations may provide that, to the extent such payment to the Fund is made more than 2½ months after the close of the taxable year, any adjustment to the tax attributable to such payment shall not affect the amount of interest payable with respect to periods before the payment is made.

(B) TREATMENT OF AMOUNTS DISTRIBUTED.—Subparagraph (A) of section 468A(c)(1) (relating to inclusion of amount distributed) is amended by striking out "subsection (e)(2)(B)"

and inserting in lieu thereof "subsection (e)(4)(B)".

(C) CLARIFICATION OF TAXATION OF FUND.—Paragraph (2) of section 468A(e) (relating to taxation of Fund) is amended to read as follows:

"(2) TAXATION OF FUND.—

"(A) IN GENERAL.—There is hereby imposed on the gross income of the Fund for any taxable year a tax at a rate equal to the maximum rate in effect under section 11(b), except that—

"(i) there shall not be included in the gross income of the Fund any payment to the Fund with respect to which a deduction is allowable under subsection (a), and

"(ii) there shall be allowed as a deduction to the Fund any amount paid by the Fund which is described in paragraph (4)(B) (other than an amount paid to the taxpayer) and which would be deductible under this chapter for purposes of determining the taxable income of a corporation.

"(B) TAX IN LIEU OF OTHER TAXATION.—The tax imposed by subparagraph (A) shall be in

lieu of any other taxation under this subtitle of the income from assets in the Fund.

"(C) FUND TREATED AS CORPORATION.—For purposes of subtitle F—

"(i) the Fund shall be treated as if it were a corporation, and

"(ii) any tax imposed by this paragraph shall be treated as a tax imposed by section 11."

(D) LIMITATION ON INVESTMENTS.—Paragraph (4) of section 468A(e) is amended by striking out "and" at the end of subparagraph (A), by striking out the period at the end of subparagraph (B) and inserting in lieu thereof ", and", and by adding at the end thereof the following new subparagraph:

"(C) to the extent that a portion of the Fund is not currently needed for purposes described in subparagraph (A) or (B), making investments described in section 501(c)(21)(B)(ii)."

(E) CLERICAL AMENDMENTS.—

(i) Subsection (a) of section 468A is amended by striking out "this subsection" and inserting in lieu thereof "this section".

(ii) Subsection (d) of section 468A is amended by striking out "this subsection" in the material preceding paragraph (1) and inserting in lieu thereof "this section".

(iii) The subsection heading for subsection (e) of section 468A is amended by striking out "TRUST FUND" and inserting in lieu thereof "RESERVE FUND".

(iv) Paragraph (1) of section 468A(e) is amended—

(I) by striking out "this subsection" and inserting in lieu thereof "this section", and

(II) by striking out "Trust Fund" and inserting in lieu thereof "Reserve Fund".

(v) Paragraph (6) of section 468A(e) is amended—

(I) by striking out "this subsection" each place it appears and inserting in lieu thereof "this section", and

(II) by striking out "this subparagraph" and inserting in lieu thereof "this paragraph".

(vi) Subsection (f) of section 468A is amended by striking out "The term" and inserting in lieu thereof "For purposes of this section, the term".

(vii) Section 88 is amended by striking out "of ratemaking purposes" and inserting in lieu thereof "for ratemaking purposes".

(F) EFFECTIVE DATE.—Subsection (g) of section 91 of the Tax Reform Act of 1984 is amended by adding at the end thereof the following new paragraph:

"(5) RULES FOR NUCLEAR DECOMMISSIONING COSTS.—The amendments made by subsections (c) and (f) shall take effect on the date of the enactment of this Act with respect to taxable years ending after such date."

(5) EFFECTIVE DATE FOR NET OPERATING LOSS PROVISIONS.—Subsection (g) of section 91 of the Tax Reform Act of 1984 is amended by adding at the end thereof the following new paragraph:

"(6) MODIFICATION OF NET OPERATING LOSS CARRYBACK PERIOD.—The amendments made by subsection (d) shall apply to losses for taxable years beginning after December 31, 1983."

(6) CLARIFICATION OF ELECTION FOR EARLIER EFFECTIVE DATE.—Subparagraph (A) of section 91(g)(2) of the Tax Reform Act of 1984 (relating to taxpayer may elect earlier application) is amended—

(A) by striking out "incurred before" and inserting in lieu thereof "incurred on or before",

(B) by striking out "incurred on or after" and inserting in lieu thereof "incurred after", and

(C) by adding at the end thereof the following new sentence:

"The Secretary of the Treasury or his delegate may by regulations provide that (in lieu of an election under the preceding sentence) a taxpayer may (subject to such conditions as such regulations may provide) elect to have subsection (h) of section 461 of such Code apply to the taxpayer's entire taxable year in which occurs July 19, 1984."

(b) AMENDMENTS RELATED TO SECTION 92 OF THE ACT.—

(1) TREATMENT OF SERVICES.—Subsection (g) of section 467 (relating to comparable rules for services) is amended by adding at the end thereof the following new sentence: "The preceding sentence shall not apply

to any amount to which section 404 or 404A (or any other provision specified in regulations) applies."

(2) CLERICAL AMENDMENTS.—

(A) Subparagraph (A) of section 467(b)(4) is amended by striking out "statutory recover period" and inserting in lieu thereof "statutory recovery period".

(B) Paragraph (4) of section 467(c) is amended by striking out "subsection (b)(3)(A)" and inserting in lieu thereof "subsection (b)(4)(A)".

(C) The last sentence of section 467(d)(2) is amended by striking out "section 1274(c)(2)(C)" and inserting in lieu thereof "section 1274(c)(4)(C)".

(D) Paragraph (5) of section 467(e) is amended by striking out "section 168(d)(4)(D)" and inserting in lieu thereof "section 168(e)(4)(D)".

SEC. 108. AMENDMENTS RELATED TO TAX STRADDLE PROVISIONS.

(a) TREATMENT OF SUBCHAPTER S CORPORATIONS.—

(1) Section 102 of the Tax Reform Act of 1984 (relating to section 1256 extended to certain options) is amended by adding at the end thereof the following new subsection:

"(j) COORDINATION OF ELECTION UNDER SUBSECTION (d)(3) WITH ELECTIONS UNDER SUBSECTIONS (g) AND (h).—The Secretary of the Treasury or his delegate shall prescribe such regulations as may be necessary to coordinate the election provided by subsection (d)(3) with the elections provided by subsections (g) and (h)."

(2) Paragraph (3) of section 102(d) of the Tax Reform Act of 1984 (relating to subchapter S election) is amended by striking out "(as so defined)" and inserting in lieu thereof "(as so defined) or such other day as may be permitted under regulations".

(b) TREATMENT OF AMOUNTS RECEIVED FOR LOANING SECURITIES.—Subparagraph (B) of section 263(g)(2) (defining interest and carrying charges) is amended by striking out "and" at the end of clause (ii), by striking out the period at the end of clause (iii) and inserting in lieu thereof ", and", and by inserting after clause (iii) the following new clause:

"(iv) any amount which is a payment with respect to a security loan (within the meaning of section 512(a)(5)) includible in gross income with respect to such property for the taxable year."

SEC. 109. AMENDMENTS RELATED TO DEPRECIATION PROVISIONS.

(a) AMENDMENTS RELATED TO SECTION 111 OF THE ACT.—

(1) CORRECTION OF TABLES.—

(A) The table contained in subparagraph (A) of section 168(b)(3) (relating to election of different recovery period) is amended by striking out "or 45" in the last item and inserting in lieu thereof "or 45 years".

(B) The table contained in subparagraph (B) of section 47(a)(5) (relating to special rules for recovery property) is amended by striking out "For 15-year, 10-year, and 5-year property" and inserting in lieu thereof "For property other than 3-year property".

(2) USE OF CONVENTIONS.—

(A) MID-MONTH CONVENTION FOR 18-YEAR REAL PROPERTY.—

(i) Paragraph (2) of section 168(b) (relating to 18-year real property) is amended—

(I) by striking out the last sentence of subparagraph (A), and

(II) by amending subparagraph (B) to read as follows:

"(B) MID-MONTH CONVENTION FOR 18-YEAR REAL PROPERTY.—In the case of 18-year real property, the amount of the deduction determined under any provision of this section (or for purposes of section 57(a)(12)(B) or 312(k)) for any taxable year shall be determined on the basis of the number of months (using a mid-month convention) in which the property is in service."

(ii) Subparagraph (B) of section 168(f)(2) (relating to recovery property used predominantly outside the United States) is amended to read as follows:

"(B) REAL PROPERTY.—Except as provided in subparagraph (C), in the case of 18-year real property or low-income housing which, during the taxable year, is predominantly used outside the United States, the recovery deduction for the taxable year shall be, in lieu of the amount determined under subsection (b), the amount determined by applying to the unadjusted basis of such property the applicable percentage determined under tables prescribed by the Secretary. For purposes of the preceding sentence, in prescribing such tables, the Secretary shall—

"(i) assign to the property described in this subparagraph a 35-year recovery period, and

"(ii) assign percentages determined in accordance with the use of the method of depreciation described in section 167(j)(1)(B), switching to the method described in section 167(b)(1) at a time to maximize the deduction allowable under subsection (a)."

(B) MONTHLY CONVENTION FOR LOW-INCOME HOUSING.—Subparagraph (B) of section 168(b)(4) (relating to low-income housing) is amended to read as follows:

"(B) MONTHLY CONVENTION.—In the case of low-income housing, the amount of the deduction determined under any provision of this section (or for purposes of section 57(a)(12)(B) or 312(k)) for any taxable year shall be determined on the basis of the number of months (treating all property placed in service or disposed of during any month as placed in service or disposed of on the first day of such month) in which the property is in service."

(C) CONFORMING AMENDMENTS.—

(i) Clause (ii) of section 168(j)(2)(B) (relating to conventions) is amended to read as follows:

"(ii) CROSS REFERENCE.—

"For other applicable conventions, see paragraphs (2)(B) and (4)(B) of subsection (b)."

(ii) Subparagraph (A) of section 312(k)(3) is amended by striking out ", and rules similar to the rules under the next to the last sentence of section 168(b)(2)(A) and section 168(b)(2)(B) shall apply".

(3) MINIMUM TAX TREATMENT.—Subparagraph (B) of section 57(a)(12) (relating to 18-year real property and low-income housing) is amended by striking out so much of such subparagaph as precedes clause (i) thereof and inserting in lieu thereof the following:

"(B) 18-YEAR REAL PROPERTY AND LOW-INCOME HOUSING.—With respect to each recovery property which is 18-year real property or low-income housing, the amount (if any) by which the deduction allowed under section 168(a) (or, in the case of property described in section 167(k), under section 167) for the taxable year exceeds the deduction which would have been allowable for the taxable year had the property been depreciated using a straight-line method (without

regard to salvage value) over a recovery period of—".

(4) TREATMENT OF PROPERTY FINANCED WITH TAX-EXEMPT BONDS.—

(A) Clause (ii) of section 168(f)(12)(B) (relating to recovery method) is amended to read as follows:

"(ii) 18-YEAR REAL PROPERTY.—In the case of 18-year real property, the amount of the deduction allowed shall be determined by using the straight-line method (without regard to salvage value) and a recovery period of 18 years."

(B) Subparagraph (C) of section 168(f)(12) (relating to exception for projects for residential rental property) is amended to read as follows:

"(C) EXCEPTION FOR LOW- AND MODERATE-INCOME HOUSING.—Subparagraph (A) shall not apply to—

"(i) any low-income housing, and

"(ii) any other recovery property which is placed in service in connection with projects for residential rental property financed by the proceeds of obligations described in section 103(b)(4)(A)."

(b) TREATMENT OF TRANSFEREE IN CERTAIN TRANSACTIONS.—

(1) IN GENERAL.—Subparagraph (A) of section 168(f)(10) (relating to transferee bound by transferor's period and method in certain cases) is amended to read as follows:

"(A) IN GENERAL.—In the case of recovery property transferred in a transaction described in subparagraph (B), for purposes of computing the deduction allowable under subsection (a) with respect to so much of the basis in the hands of the transferee as does not exceed the adjusted basis in the hands of the transferor—

"(i) if the transaction is described in subparagraph (B)(i), the transferee shall be treated in the same manner as the transferor, or

"(ii) if the transaction is described in clause (ii) or (iii) of subparagraph (B) and the transferor made an election with respect to such property under subsection (b)(3) or (f)(2)(C), the transferee shall be treated as having made the same election (or its equivalent)."

(2) TREATMENT OF TERMINATIONS OF PARTNERSHIPS.—Subparagraph (B) of section 168(f)(10) is amended by adding at the end thereof the following new sentence:

"Clause (i) shall not apply in the case of the termination of a partnership under section 708(b)(1)(B)."

(3) EFFECTIVE DATE.—The amendments made by this subsection shall apply to property placed in service by the transferee after March 28, 1985, in taxable years ending after such date.

(c) AMENDMENTS RELATED TO SECTION 113 OF THE ACT.—

(1) TREATMENT OF FILMS, VIDEO TAPES, AND SOUND RECORDINGS.—Except with respect to property placed in service by the taxpayer on or before March 28, 1985, subsection (c) of section 167 (relating to limitations on use of certain methods and rates) is amended by adding at the end thereof the following new sentence:

"For purposes of the preceding sentence, any motion picture film, video tape, or sound recording shall be treated as intangible property."

(2) CLERICAL AMENDMENT.—Subsection (q) of section 48 is amended by redesignating the paragraph

relating to special rule for qualified films as paragraph (7).

(d) AMENDMENTS RELATED TO SECTION 114 OF THE ACT.—

(1) Paragraph (1) of section 48(b) (defining new section 38 property) is amended by adding at the end thereof the following new sentence: "Such term includes any section 38 property the reconstruction of which is completed by the taxpayer."

(2) Paragraph (2) of section 48(b) (relating to special rule for sale-leasebacks) is amended—

(A) by striking out "paragraph (1)" and inserting in lieu thereof "the first sentence of paragraph (1)", and

(B) by striking out "used under the lease" and inserting in lieu thereof "used under the leaseback (or lease) referred to in subparagraph (B)".

SEC. 110. AMENDMENTS RELATED TO FOREIGN PROVISIONS.

(a) AMENDMENTS RELATED TO SECTION 121 OF THE ACT.—

(1) TREATMENT OF CERTAIN DOMESTIC CORPORATIONS.—

(A) IN GENERAL.—Subsection (g) of section 904 (relating to source rules in the case of United

States-owned foreign corporations) is amended by redesignating paragraph (9) as paragraph (10), and by inserting after paragraph (8) the following new paragraph:

"(9) TREATMENT OF CERTAIN DOMESTIC CORPORATIONS.—For purposes of this subsection—

"(A) in the case of interest treated as not from sources within the United States under section 861(a)(1)(B), the corporation paying such interest shall be treated as a United States-owned foreign corporation, and

"(B) in the case of any dividend treated as not from sources within the United States under section 861(a)(2)(A), the corporation paying such dividend shall be treated as a United States-owned foreign corporation."

(B) EFFECTIVE DATE.—The amendment made by subparagraph (A) shall take effect on March 28, 1985. In the case of any taxable year ending after such date of any corporation treated as a United States-owned foreign corporation by reason of the amendment made by subparagraph (A)—

(i) only income received or accrued by such corporation after such date shall be

taken into account under section 904(g) of the Internal Revenue Code of 1954; except that

(ii) paragraph (5) of such section 904(g) shall be applied by taking into account all income received or accrued by such corporation during such taxable year.

(2) TREATMENT OF CERTAIN FOREIGN CORPORATIONS ENGAGED IN TRADE OR BUSINESSES WITHIN UNITED STATES.—Subparagraph (E) of section 121(b)(2) of the Tax Reform Act of 1984 (relating to special rules for applicable CFC) is amended by adding at the end thereof the following new clause:

"(iii) TREATMENT OF CERTAIN FOREIGN CORPORATIONS ENGAGED IN BUSINESS IN UNITED STATES.—For purposes of clause (ii), a foreign corporation shall be treated as a United States person with respect to any interest payment made by such corporation if—

"(I) at least 50 percent of the gross income from all sources of such corporation for the 3-year period ending with the close of its last taxable year ending on or before March 31, 1984,

was effectively connected with the conduct of a trade or business within the United States, and

"(II) at least 50 percent of the gross income from all sources of such corporation for the 3-year period ending with the close of its taxable year preceding the payment of such interest was effectively connected with the conduct of a trade or business within the United States."

(3) TREATMENT OF CERTAIN SHORT-TERM BORROWING.—Clause (ii) of section 121(b)(2)(D) of the Tax Reform Act of 1984 (defining applicable CFC) is amended by striking out "or the holding of short-term obligations" and all that follows and inserting in lieu thereof "(or short-term borrowing from nonaffiliated persons) and lending the proceeds of such obligations (or such borrowing) to affiliates."

(b) AMENDMENTS RELATED TO SECTION 122 OF THE ACT.—

(1) TREATMENT OF SUBPART F AND FOREIGN PERSONAL HOLDING COMPANY INCLUSIONS.—Subparagraph (C) of section 904(d)(3) (relating to exception where designated corporation has small amount of

separate limitation interest) is amended by adding at the end thereof the following new sentence:

"The preceding sentence shall not apply to any amount includible in gross income under section 551 or 951."

(2) TREATMENT OF INTEREST AND DIVIDENDS FROM MEMBERS OF SAME AFFILIATED GROUP.—Paragraph (3) of section 904(d) (relating to certain amounts attributable to United States-owned foreign corporations, etc., treated as interest) is amended by striking out subparagraph (J), by redesignating subparagrah (I) as subparagraph (J), and by inserting after subparagraph (H) the following new subparagraph:

"(I) INTEREST AND DIVIDENDS FROM MEMBERS OF SAME AFFILIATED GROUP.—For purposes of this paragraph, dividends and interest received or accrued by the designated payor corporation from another member of the same affiliated group (determined under section 1504 without regard to subsection (b)(3) thereof) shall be treated as separate limitation interest if (and only if) such amounts are attributable (directly or indirectly) to separate limitation interest of any other member of such group."

(3) DEFINITION OF DESIGNATED PAYOR CORPORATION.—

(A) IN GENERAL.—Subparagraph (E) of section 904(d)(3) (defining designated payor corporation) is amended by striking out "and" at the end of clause (ii), by striking out the period at the end of clause (iii) and inserting in lieu thereof ", and", and by adding at the end thereof the following:

"(iv) any other corporation formed or availed of for purposes of avoiding the provisions of this paragraph.

For purposes of this paragraph, the rules of paragraph (9) of subsection (g) shall apply."

(B) EFFECTIVE DATE.—The amendment made by subparagraph (A) shall take effect on March 28, 1985. In the case of any taxable year ending after such date of any corporation treated as a designated payor corporation by reason of the amendment made by subparagraph (A)—

(i) only income received or accrued by such corporation after such date shall be taken into account under section 904(d)(3) of the Internal Revenue Code of 1954; except that

(ii) subparagraph (C) of such section 904(d)(3) shall be applied by taking into account all income received or accrued by such corporation during such taxable year.

(c) AMENDMENTS RELATED TO SECTION 123 OF THE ACT.—

(1) Subparagraph (A) of section 956(b)(3) (relating to certain trade or service receivables acquired from related United States persons) is amended by striking out "paragraph (2)" and inserting in lieu thereof "paragraph (2) (other than subparagraph (H) thereof)".

(2) Subsection (d) of section 864 (relating to treatment of related person factoring income) is amended by redesignating paragraph (7) as paragraph (8) and by inserting after paragraph (6) the following new paragraph:

"(7) EXCEPTION FOR CERTAIN RELATED PERSONS DOING BUSINESS IN SAME FOREIGN COUNTRY.—Paragraph (1) shall not apply to any trade or service receivable acquired by any person from a related person if—

"(A) the person acquiring such receivable and such related person are created or organized under the laws of the same foreign country and such related person has a substantial part of its

assets used in its trade or business located in such same foreign country, and

"(B) such related person would not have derived any foreign base company income (as defined in section 954(a), determined without regard to section 954(b)(3)(A)), or any income effectively connected with the conduct of a trade or business within the United States, from such receivable if it had been collected by such related person."

(d) AMENDMENTS RELATED TO SECTION 127 OF THE ACT.—

(1) DEFINITION OF PORTFOLIO INTEREST.—

(A) Paragraph (2) of section 871(h) (defining portfolio interest) is amended by striking out "which is described in" in the matter preceding subparagraph (A) and inserting in lieu thereof "which would be subject to tax under subsection (a) but for this subsection and which is described in".

(B) Paragraph (2) of section 881(c) (defining portfolio interest) is amended by striking out "which is described in" in the matter preceding subparagraph (A) and inserting in lieu thereof "which would be subject to tax under subsection

(a) but for this subsection and which is described in".

(2) TREATMENT OF CERTAIN FOREIGN-OWNED FINANCING AFFILIATES.—Paragraph (3) of section 127(g) of the Tax Reform Act of 1984 (relating to special rule for certain United States affiliate obligations) is amended by adding at the end thereof the following new subparagraph:

"(D) TREATMENT OF CERTAIN FOREIGN-OWNED FINANCING AFFILIATES.—

"(i) EXTENSION OF PARAGRAPH.—To the extent provided in regulations, rules similar to the rules of subparagraphs (A) and (B) shall apply with respect to a corporation which would be an applicable CFC but for inadequate ownership by United States persons.

"(ii) REDUCTION OF INTEREST DEDUCTION.—In any case to which clause (i) applies, the deduction for interest paid by an affiliate to the corporation described in clause (i) shall be appropriately reduced to reflect the spread between the interest rates involved or to prevent the shifting of income from the affiliate to other affiliates.

"(iii) AFFILIATE.—For purposes of clause (ii), the term 'affiliate' means any person who is a related person (within the meaning of section 482 of the Internal Revenue Code of 1954) to the corporation described in clause (i)."

(3) CLERICAL AMENDMENTS.—

(A) Paragraph (1) of section 871(a) is amended by striking out "provided in subsection (i)" in the matter preceding subparagraph (A), and inserting in lieu thereof "provided in subsection (h)".

(B) Clause (ii) of section 871(h)(2)(B) is amended by striking out "has received" and inserting in lieu thereof "receives".

(C) Clause (ii) of section 881(c)(2)(B) is amended by striking out "has received" and inserting in lieu thereof "receives".

(D) Paragraph (9) of section 1441(c) is amended by striking out "871(h)(2)" and inserting in lieu thereof "section 871(h)".

(E) Subsection (a) of section 1442 is amended—

(i) by striking out "sections 871(h)(2)" and inserting in lieu thereof "sections 871(h)", and

(ii) by striking out "sections 881(c)(2)" and inserting in lieu thereof "sections 881(c)".

(e) AMENDMENTS RELATED TO SECTION 128 OF THE ACT.—

(1) DEDUCTION FOR ORIGINAL ISSUE DISCOUNT.—

(A) Subparagraph (A) of section 163(e)(3) (relating to special rule for original issue discount on obligation held by related foreign person) is amended by adding at the end thereof the following new sentence: "The preceding sentence shall not apply to the extent that the original issue discount is effectively connected with the conduct by such foreign related person of a trade or business within the United States unless such original issue discount is exempt from taxation (or is subject to a reduced rate of tax) pursuant to a treaty obligation of the United States."

(B) Subsection (e) of section 163 is amended by redesignating the paragraph relating to cross references as paragraph (5).

(2) TAXATION OF ORIGINAL ISSUE DISCOUNT.—

(A) Subparagraph (C) of section 871(a)(1) (relating to income not connected with United States business) is amended to read as follows:

"(C) in the case of—

"(i) a sale or exchange of an original issue discount obligation, the amount of the original issue discount accruing while such obligation was held by the nonresident alien individual (to the extent such discount was not theretofore taken into account under clause (ii)), and

"(ii) a payment on an original issue discount obligation, an amount equal to the original issue discount accruing while such obligation was held by the nonresident alien individual (except that such original issue discount shall be taken into account under this clause only to the extent such discount was not theretofore taken into account under this clause and only to the extent that the tax thereon does not exceed the payment less the tax imposed by subparagraph (A) thereon), and".

(B) Paragraph (3) of section 881 (relating to tax on income of foreign corporations not connected with United States business) is amended to read as follows:

"(3) in the case of—

"(A) a sale or exchange of an original issue discount obligation, the amount of the original issue discount accruing while such obligation was held by the foreign corporation (to the extent such discount was not theretofore taken into account under subparagraph (B)), and

"(B) a payment on an original issue discount obligation, an amount equal to the original issue discount accruing while such obligation was held by the foreign corporation (except that such original issue discount shall be taken into account under this subparagraph only to the extent such discount was not theretofore taken into account under this subparagraph and only to the extent that the tax thereon does not exceed the payment less the tax imposed by paragraph (1) thereon), and".

(f) AMENDMENTS RELATED TO SECTION 129 OF THE ACT.—

(1) TREATMENT OF ELECTIONS UNDER SECTION 897(i).—

(A) Paragraph (1) of section 897(i) (relating to election by foreign corporation to be treated as domestic corporation) is amended by striking out "and section 6039C" and inserting in lieu thereof "section 1445, and section 6039C".

(B) Paragraph (4) of section 897(i) is amended by striking out "this section and section 6039C" and inserting in lieu thereof "this section, section 1445, and section 6039C".

(2) EXEMPTION FOR INTERESTS IN CERTAIN CORPORATIONS.—Paragraph (3) of section 1445(b) (relating to nonpublicly traded domestic corporation funishing affidavit that it is not a United States real property holding corporation) is amended to read as follows:

"(3) NONPUBLICLY TRADED DOMESTIC CORPORATION FURNISHES AFFIDAVIT THAT INTERESTS IN CORPORATION NOT UNITED STATES REAL PROPERTY INTERESTS.—Except as provided in paragraph (7), this paragraph applies in the case of a disposition of any interest in any domestic corporation if the domestic corporation furnishes to the transferee an affidavit by the domestic corporation stating, under penalty of perjury, that—

"(A) the domestic corporation is not and has not been a United States real property holding corporation (as defined in section 897(c)(2)) during the applicable period specified in section 897(c)(1)(A)(ii), or

"(B) as of the date of the disposition, interests in such corporation are not United States real property interests by reason of section 897(c)(1)(B)."

(3) NOTICE OF FALSE AFFIDAVIT.—

(A) Clause (i) of section 1445(d)(1)(B) (relating to notice of false affidavit; foreign corporations) is amended to read as follows:

"(i) any transferor's agent—

"(I) such agent has actual knowledge that such affidavit is false, or

"(II) in the case of an affidavit described in subsection (b)(2) furnished by a corporation, such corporation is a foreign corporation, or".

(B) Paragraph (1) of section 1445(d) is amended by striking out "described in paragraph (2)(A)" and inserting in lieu thereof "described in paragraph (2)".

(4) TREATMENT OF CERTAIN DOMESTIC PARTNERSHIPS, TRUSTS, AND ESTATES.—

(A) IN GENERAL.—Paragraph (1) of section 1445(e) (relating to certain domestic partnerships, trusts, and estates) is amended to read as follows:

"(1) CERTAIN DOMESTIC PARTNERSHIPS, TRUSTS, AND ESTATES.—In the case of any disposition of a United States real property interest as defined in section 897(c) (other than a disposition described in paragraph (4) or (5)) by a domestic partnership, domestic trust, or domestic estate, such partnership, the trustee of such trust, or the executor of such estate (as the case may be) shall be required to deduct and withhold under subsection (a) a tax equal to 28 percent of the gain realized to the extent such gain—

"(A) is currently taken into account with respect to a foreign person who is a partner or beneficiary of such partnership, trust, or estate, or

"(B) is allocable to a portion of the trust treated as owned by a foreign person under subpart E of part I of subchapter J."

(B) EFFECTIVE DATE.—The amendment made by subparagraph (A) shall apply to dispositions after the day 30 days after the date of the enactment of this Act.

(5) DISTRIBUTIONS BY DOMESTIC CORPORATIONS TO FOREIGN SHAREHOLDER.—Paragraph (3) of section 1445(e) (relating to distributions by certain domestic corporations to foreign shareholders) is amended by adding at the end thereof the following new sentence: "The preceding sentence shall not apply if, as of the date of the distribution, interests in such corporation are not United States real property interests by reason of section 897(c)(1)(B)."

(6) CERTAIN TAXABLE DISTRIBUTIONS.—Paragraph (4) of section 1445(e) (relating to taxable distributions by domestic or foreign partnerships, trusts, or estates) is amended by striking out "section 897(g)" and inserting in lieu thereof "section 897".

(7) PAYMENT OF TAX.—Subsection (d) of section 6039C (relating to special rule for United States interests and Virgin Islands interests) is amended by striking out "subject to tax under section 897(a)" and inserting in lieu thereof "subject to tax under section 897(a) (and any person required to withhold tax under section 1445)".

(8) CONFORMING AMENDMENTS TO SECTION 6652(g).—

(A) Paragraph (1) of section 6652(g) (relating to returns, etc., required under section 6039C) is amended to read as follows:

"(1) IN GENERAL.—In the case of each failure to make a return required by section 6039C which contains the information required by such section on the date prescribed therefor (determined with regard to any extension of time for filing), unless it is shown that such failure is due to reasonable cause and not to willful neglect, the amount determined under paragraph (2) shall be paid (upon notice and demand by the Secretary and in the same manner as tax) by the person failing to make such return."

(B) Paragraph (3) of section 6652(g) is amended to read as follows:

"(3) LIMITATION.—The amount determined under paragraph (2) with respect to any person for failing to meet the requirements of section 6039C for any calendar year shall not exceed the lesser of—

"(A) $25,000, or

"(B) 5 percent of the aggregate of the fair market value of the United States real property interests owned by such person at any time during such year.

For purposes of the preceding sentence, fair market value shall be determined as of the end of the calendar year (or, in the case of any property disposed of during the calendar year, as of the date of such disposition)."

(C) The subsection heading for subsection (g) of section 6652 is amended by striking out ", ETC.,".

(g) AMENDMENTS RELATED TO SECTION 131 OF THE ACT.—

(1) Subsection (f) of section 367 (relating to transitional rule) is hereby repealed.

(2) Paragraph (1) of section 7482(b) (relating to venue) is amended by striking out "section 7428, 7476, or 7477" and inserting in lieu thereof "section 7428 or 7476".

(3) Paragraph (8) of section 6501(c) (relating to failure to notify the Secretary under section 6038B) is amended—

(A) by striking out "subsection (a) or (d)" and inserting in lieu thereof "subsection (a), (d), or (e)", and

(B) by striking out "exchange" each place it appears and inserting in lieu thereof "exchange or distribution".

(h) AMENDMENTS RELATED TO SECTION 132 OF THE ACT.—

(1) Subsection (c) of section 552 (relating to certain dividends and interest not taken into account) is amended by adding at the end thereof the following new sentence:

"For purposes of the preceding sentence, the term 'related person' has the meaning given such term by section 954(d)(3) (determined by substituting 'foreign personal holding company' for 'controlled foreign corporation' each place it appears)."

(2) Paragraph (1) of section 551(f) (relating to stock held through foreign entity) is amended by striking out "United States shareholder" and inserting in lieu thereof "United States shareholder or an estate or trust which is a foreign estate or trust".

(i) AMENDMENT RELATED TO SECTION 133 OF THE ACT.—Subparagraph (B) of section 1248(i)(1) (relating to treatment of certain indirect transfers) is amended by striking out "in redemption of his stock" and inserting in lieu thereof "in redemption or liquidation (whichever is appropriate)".

(j) AMENDMENTS RELATED TO SECTION 136 OF THE ACT.—

(1) COLLECTION OF TAX.—Subsection (b) of section 269B (relating to stapled entities) is amended by

inserting before the period at the end thereof the following: "and regulations providing that any tax imposed on the foreign corporation referred to in subsection (a)(1) may, if not paid by such corporation, be collected from the domestic corporation referred to in such subsection or the shareholders of such foreign corporation".

(2) EXCEPTION WHERE CORPORATIONS OWNED BY FOREIGN PERSONS.—Section 269B is amended by adding at the end thereof the following new subsection:

"(e) SUBSECTION (a)(1) NOT TO APPLY IN CERTAIN CASES.—

"(1) IN GENERAL.—Subsection (a)(1) shall not apply if it is established to the satisfaction of the Secretary that the domestic corporation and the foreign corporation referred to in such subsection are foreign owned.

"(2) FOREIGN OWNED.—For purposes of paragraph (1), a corporation is foreign owned if less than 50 percent of—

"(A) the total combined voting power of all classes of stock of such corporation entitled to vote, and

"(B) the total value of the stock of the corporation,

is held directly (or indirectly through applying paragraphs (2) and (3) of section 958(a) and paragraph (4) of section 318(a)) by United States persons (as defined in section 7701(a)(30))."

(k) AMENDMENT RELATED TO SECTION 137 OF THE ACT.—Subsection (e) of section 954 (defining foreign base company services income) is amended to read as follows:

"(e) FOREIGN BASE COMPANY SERVICES INCOME.—

"(1) IN GENERAL.—For purposes of subsection (a)(3), the term 'foreign base company services income' means income (whether in the form of compensation, commissions, fees, or otherwise) derived in connection with the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services which—

"(A) are performed for or on behalf of any related person (within the meaning of subsection (d)(3)), and

"(B) are performed outside the country under the laws of which the controlled foreign corporation is created or organized.

"(2) EXCEPTION.—Paragraph (1) shall not apply to income derived in connection with the performance of services which are directly related to—

"(A) the sale or exchange by the controlled foreign corporation of property manufactured, produced, grown, or extracted by it and which are performed before the time of the sale or exchange, or

"(B) an offer or effort to sell or exchange such property.

"(3) TREATMENT OF CERTAIN INSURANCE CONTRACTS.—For purposes of paragraph (1), in the case of any services performed with respect to any policy of insurance or reinsurance with respect to which the primary insured is a related person (within the meaning of section 864(d)(4))—

"(A) such primary insured shall be treated as a related person for purposes of paragraph (1)(A) (whether or not the requirements of subsection (d)(3) are met),

"(B) such services shall be treated as performed in the country within which the insured hazards, risks, losses, or liabilities occur, and

"(C) except as otherwise provided in regulations by the Secretary, rules similar to the rules of section 953(b) shall be applied in determining the income from such services."

(l) AMENDMENT RELATED TO SECTION 138 OF THE ACT.—Clause (i) of section 7701(b)(4)(E) (relating to limitation of teachers and trainees) is amended by adding at the end thereof the following new sentence: "In the case of an individual all of whose compensation is described in section 872(b)(3), the preceding sentence shall be applied by substituting '4 calendar years' for '2 calendar years'."

SEC. 111. AMENDMENTS RELATED TO REPORTING, PENALTY, AND OTHER PROVISIONS.

(a) AMENDMENTS RELATED TO SECTION 145 OF THE ACT.—

(1) Section 6050H (relating to returns relating to mortgage interest received in trade or business from individuals) is amended by adding at the end thereof the following new subsection:

"(g) SPECIAL RULES FOR COOPERATIVE HOUSING CORPORATIONS.—For purposes of subsection (a), an amount received by a cooperative housing corporation from a tenant-stockholder shall be deemed to be interest received on a mortgage in the course of a trade or business engaged in by such corporation, to the extent of the tenant-stockholder's proportionate share of interest described in section 216(a)(2). Terms used in the preceding sentence shall have the same meanings as when used in section 216."

(2) Paragraph (2) of section 145(d) of the Tax Reform Act of 1984 is amended by striking out "section 6652" and inserting in lieu thereof "section 6676".

(b) AMENDMENT RELATED TO SECTION 149 OF THE ACT.—Paragraph (2) of section 6050K(c) (relating to requirement that transferor notify partnership) is amended by striking out "this subsection" and inserting in lieu thereof "this section".

(c) AMENDMENT RELATED TO SECTION 157 OF THE ACT.—Paragraph (3) of section 7502(e) is amended by striking out "the tax" and inserting in lieu thereof "any tax".

SEC. 112. AMENDMENTS RELATED TO MISCELLANEOUS PROVISIONS.

(a) AMENDMENTS RELATED TO SECTION 171 OF THE ACT.—

(1) Subsection (a) of section 111 (relating to recovery of tax benefit items) is amended by striking out "did not reduce income subject to tax" and inserting in lieu thereof "did not reduce the amount of tax imposed by this chapter".

(2) Subsection (c) of section 111 (relating to treatment of carryovers) is amended by striking out "reducing income subject to tax or reducing tax imposed by

this chapter, as the case may be" and inserting in lieu thereof "reducing tax imposed by this chapter".

(3) Paragraph (12) of section 381(c) (relating to recovery of bad debts, prior taxes, or delinquency amounts) is amended to read as follows:

"(12) RECOVERY OF TAX BENEFIT ITEMS.—If the acquiring corporation is entitled to the recovery of any amounts previously deducted by (or allowable as credits to) the distributor or transferor corporation, the acquiring corporation shall succeed to the treatment under section 111 which would apply to such amounts in the hands of the distributor or transferor corporation."

(4) Paragraph (2) of section 1351(d) is amended by striking out "relating to recovery of bad debts, etc.," and inserting in lieu thereof "relating to recovery of tax benefit items".

(5) Paragraph (3) of section 1398(g) is amended to read as follows:

"(3) RECOVERY OF TAX BENEFIT ITEMS.—Any amount to which section 111 (relating to recovery of tax benefit items) applies."

(b) AMENDMENTS RELATED TO SECTION 172 OF THE ACT.—

(1) COORDINATION OF SECTION 7872 WITH TAXES ON PRIVATE FOUNDATIONS.—Subparagraph (B) of section 4941(d)(2) (defining self-dealing) is amended by striking out "without interest or other charge" and inserting in lieu thereof "without interest or other charge (determined without regard to section 7872)".

(2) COORDINATION WITH WITHHOLDING.—Paragraph (9) of section 7872(f) (relating to no withholding) is amended to read as follows:

"(9) NO WITHHOLDING.—No amount shall be withheld under chapter 24 with respect to—

"(A) any amount treated as transferred or retransferred under subsection (a), and

"(B) any amount treated as received under subsection (b)."

(3) DEFINITION OF DEMAND LOAN.—Paragraph (5) of section 7872(f) (defining demand loan) is amended by adding at the end thereof the following new sentence: "To the extent provided in regulations, such term includes any loan with an indefinite maturity."

(4) CLARIFICATION OF APPLICABLE FEDERAL RATE.—Subparagraph (B) of section 7872(f)(2) (defining applicable Federal rate) is amended by inserting ",

compounded semiannually" immediately before the period at the end thereof.

(c) AMENDMENTS RELATED TO SECTION 174 OF THE ACT.—

(1) TREATMENT OF FOREIGN PERSONS.—Subsection (a) of section 267 is amended by adding at the end thereof the following new paragraph:

"(3) PAYMENTS TO FOREIGN PERSONS.—The Secretary shall by regulations apply the matching principle of paragraph (2) in cases in which the person to whom the payment is to be made is not a United States person."

(2) CLERICAL AMENDMENT.—Paragraph (12) of section 267(b) (defining related persons) is amended by striking out "same persons owns" and inserting in lieu thereof "same persons own".

(d) AMENDMENTS RELATED TO SECTION 177 OF THE ACT.—

(1) CLARIFICATION OF TREATMENT OF DIVIDENDS PAID BY FEDERAL HOME LOAN BANKS.—

(A) Subparagraph (B) of section 246(a)(2) (relating to certain dividends of Federal home loan banks) is amended—

(i) by striking out "For purposes of subparagraph (A), in" and inserting in lieu thereof "In", and

(ii) by striking out subclause (II) of clause (i) and inserting in lieu thereof the following:

"(II) which were not previously treated as distributed under subparagraph (A) or this subparagraph, bears to."

(B) Paragraph (2) of section 246(a) (relating to subsection not to apply to certain dividends of Federal Home Loan Banks) is amended by redesignating subparagraph (C) as subparagraph (D) and by inserting after subparagraph (B) the following new subparagraph:

"(C) COORDINATION WITH SECTION 243.—To the extent that paragraph (1) does not apply to any dividend by reason of subparagraph (A) or (B) of this paragraph, the requirement contained in section 243(a) that the corporation paying the dividend be subject to taxation under this chapter shall not apply."

(2) CLARIFICATION OF EFFECTIVE DATE.—Paragraph (4) of section 177(d) of the Tax Reform Act of

1984 (relating to effective dates) is amended to read as follows:

"(4) CLARIFICATION OF EARNINGS AND PROFITS OF FEDERAL HOME LOAN MORTGAGE CORPORATION.—

"(A) TREATMENT OF DISTRIBUTION OF PREFERRED STOCK, ETC.—For purposes of the Internal Revenue Code of 1954, the distribution of preferred stock by the Federal Home Loan Mortgage Corporation during December of 1984, and the other distributions of such stock by Federal Home Loan Banks during January of 1985, shall be treated as if they were distributions of money equal to the fair market value of the stock on the date of the distribution by the Federal Home Loan Banks (and such stock shall be treated as if it were purchased with the money treated as so distributed). No deduction shall be allowed under section 243 of the Internal Revenue Code of 1954 with respect to any dividend paid by the Federal Home Loan Mortgage Corporation out of earnings and profits accumulated before January 1, 1985.

"(B) SECTION 246(a) NOT TO APPLY TO DISTRIBUTIONS OUT OF EARNINGS AND PROFITS

ACCUMULATED DURING 1985.—Subsection (a) of section 246 of the Internal Revenue Code of 1954 shall not apply to any dividend paid by the Federal Home Loan Mortgage Corporation during 1985 out of earnings and profits accumulated after December 31, 1984."

(e) AMENDMENTS RELATED TO SECTION 179 OF THE ACT.—

(1) CLARIFICATION OF DEFINITION OF PASSENGER AUTOMOBILE.—

(A) SECTION 280F.—Clause (ii) of section 280F(d)(5)(A) (defining passenger automobile) is amended by striking out "gross vehicle weight" and inserting in lieu thereof "unloaded gross vehicle weight".

(B) GAS GUZZLER TAX.—

(i) Clause (ii) of section 4064(b)(1)(A) (defining passenger automobile) is amended by striking out "gross vehicle weight" and inserting in lieu thereof "unloaded gross vehicle weight".

(ii) The amendment made by clause (i) shall take effect as if included in the amendments made by section 201(a) of Public Law 95–618.

(2) DEDUCTIONS OF EMPLOYEE FOR USE OF LISTED PROPERTY.—Subparagraph (A) of section 280F(d)(3) (relating to deductions of employee) is amended by striking out "recovery deduction allowable to the employee" and inserting in lieu thereof "recovery deduction allowable to the employee (or the amount of any deduction allowable to the employee for rentals or other payments under a lease of listed property)".

(3) TREATMENT OF CERTAIN COMPUTERS.—Subparagraph (B) of section 280F(d)(4) (relating to exception for certain computers) is amended by striking out "at a regular business establishment" and inserting in lieu thereof "at a regular business establishment and owned or leased by the person operating such establishment".

(4) CLERICAL AMENDMENT.—Paragraph (2) of section 280F(d) (relating to subsequent depreciation deductions reduced for deductions allocable to personal use) is amended by striking out "is not use described in" and inserting in lieu thereof "is use described in".

PART B—AMENDMENTS RELATED TO TITLE II OF THE ACT

SEC. 121. AMENDMENTS RELATED TO SECTION 211 OF THE ACT.

(a) CERTAIN AMOUNTS NOT LESS THAN SURRENDER VALUE OF CONTRACT.—Subsection (c) of section 807 (relating to rules for certain reserves) is amended by adding at the end thereof the following new sentence: "In no case shall the amount determined under paragraph (3) for any contract be less than the net surrender value of such contract."

(b) CLARIFICATION OF DEFINITION OF EXCESS INTEREST.—Subparagraph (B) of section 808(d)(1) (defining excess interest) is amended to read as follows:

"(B) in excess of interest determined at the prevailing State assumed rate for such contract."

(c) COORDINATION OF 1984 FRESH-START ADJUSTMENT WITH CERTAIN ACCELERATIONS OF POLICYHOLDER DIVIDENDS DEDUCTIONS.—Section 808 (relating to policyholder dividends deduction) is amended by adding at the end thereof the following new subsection:

"(f) COORDINATION OF 1984 FRESH-START ADJUSTMENT WITH ACCELERATION OF POLICYHOLDER DIVIDENDS DEDUCTION THROUGH CHANGE IN BUSINESS PRACTICE.—

"(1) IN GENERAL.—The amount determined under paragraph (1) of subsection (c) for the year of

change shall (before any reduction under paragraph (2) of subsection (c)) be reduced by so much of the accelerated policyholder dividends deduction for such year as does not exceed the 1984 fresh-start adjustment for policyholder dividends (to the extent such adjustment was not previously taken into account under this subsection).

"(2) YEAR OF CHANGE.—For purposes of this subsection, the term 'year of change' means the taxable year in which the change in business practices which results in the accelerated policyholder dividends deduction takes effect.

"(3) ACCELERATED POLICYHOLDER DIVIDENDS DEDUCTION DEFINED.—For purposes of this subsection, the term 'accelerated policyholder dividends deduction' means the amount which (but for this subsection) would be determined for the taxable year under paragraph (1) of subsection (c) but which would have been determined (under such paragraph) for a later taxable year under the business practices of the taxpayer as in effect at the close of the preceding taxable year.

"(4) 1984 FRESH-START ADJUSTMENT FOR POLICYHOLDER DIVIDENDS.—For purposes of this subsection, the term '1984 fresh-start adjustment for policyholder dividends' means the amounts held as of De-

cember 31, 1983, by the taxpayer as reserves for dividends to policyholders under section 811(b) (as in effect on the day before the date of the enactment of the Tax Reform Act of 1984) other than for dividends which accrued before January 1, 1984. Such amounts shall be properly reduced to reflect the amount of previously nondeductible policyholder dividends (as determined under section 809(f) as in effect on the day before the date of the enactment of the Tax Reform Act of 1984).

"(5) SEPARATE APPLICATION WITH RESPECT TO LINES OF BUSINESS.—This subsection shall be applied separately with respect to each line of business of the taxpayer.

"(6) SUBSECTION NOT TO APPLY TO MERE CHANGE IN DIVIDEND AMOUNT.—This subsection shall not apply to a mere change in the amount of policyholder dividends."

(d) CLARIFICATION OF EQUITY BASE.—Paragraph (2) of section 809(b) (defining equity base) is amended by adding at the end thereof the following new sentence:

"No item shall be taken into account more than once in determining equity base."

(e) DEFINITION OF 50 LARGEST STOCK COMPANIES.—Subparagraph (C) of section 809(d)(4) (defining 50 largest stock companies) is amended—

(1) by striking out "the equity of such company" and inserting in lieu thereof "the surplus and capital of such company", and

(2) by striking out "on the basis of equity" and inserting in lieu thereof "on the basis of surplus and capital".

(f) CLARIFICATION OF STATEMENT GAIN OR LOSS FROM OPERATIONS.—Paragraph (1) of section 809(g) (defining statement gain or loss from operations) is amended by striking out so much of such paragraph as precedes subparagraph (B) and inserting in lieu thereof the following:

"(1) STATEMENT GAIN OR LOSS FROM OPERATIONS.—The term 'statement gain or loss from operations' means the net gain or loss from operations required to be set forth in the annual statement, determined without regard to Federal income taxes and—

"(A) determined by substituting for the amount shown for policyholder dividends the amount of deduction for policyholder dividends determined under section 808 (without regard to section 808(c)(2)),".

(g) MOST RECENT DIFFERENTIAL EARNINGS RATE MAY BE USED FOR PURPOSES OF ESTIMATED TAX PAYMENTS.—Subsection (c) of section 809 (defining differential

earnings rate) is amended by adding at the end thereof the following new paragraph:

"(3) COORDINATION WITH ESTIMATED TAX PAYMENTS.—

"(A) IN GENERAL.—If, with respect to any installment of estimated tax—

"(i) the most recent published differential earnings rate, is less than

"(ii) the differential earnings rate applicable under paragraph (1) to the taxable year for which the installment is paid,

for purposes of applying section 6655 with respect to such installment, the amount of tax shall be determined by using the most recent published differential earnings rate.

"(B) MOST RECENT PUBLISHED DIFFERENTIAL EARNINGS RATE.—For purposes of subparagraph (A), the term 'most recent published differential earnings rate' means the most recent differential earnings rate published by the Secretary (determined as of the day 30 days before the date prescribed for payment of the installment of estimated tax)."

(h) AMENDMENTS RELATED TO PRORATION FORMULAS.—

(1) Paragraph (2) of section 812(b) is amended—

(A) by striking out "the prevailing State assumed rate" in subparagraph (A) and inserting in lieu thereof "the prevailing State assumed rate or, where such rate is not used, another appropriate rate",

(B) by striking out "and" at the end of subparagraph (B),

(C) by striking out the period at the end of subparagraph (C) and inserting in lieu thereof ", and", and

(D) by adding at the end thereof the following new subparagraph:

"(D) interest on amounts left on deposit with the company."

(2) Subparagraph (B) of section 812(b)(3) (relating to gross investment income's proportionate share of policyholder dividends) is amended—

(A) by striking out "(including tax-exempt interest)" in clause (ii), and

(B) by adding at the end thereof the following new sentence:

"For purposes of subparagraph (B)(ii), life insurance gross income shall be determined by including tax-exempt interest and by applying section

807(a)(2)(B) as if it did not contain clause (i) thereof."

(3) Subsection (c) of section 812 (defining net investment income) is amended to read as follows:

"(c) NET INVESTMENT INCOME.—For purposes of this section, the term 'net investment income' means—

"(1) except as provided in paragraph (2), 90 percent of gross investment income; or

"(2) in the case of gross investment income attributable to assets held in segregated asset accounts under variable contracts, 95 percent of gross investment income."

(4) Section 812 is amended by adding at the end thereof the following new subsection:

"(g) TREATMENT OF INTEREST PARTIALLY TAX-EXEMPT UNDER SECTION 133.—For purposes of this section and subsections (a) and (b) of section 807, the terms 'gross investment income' and 'tax-exempt interest' shall not include any interest received with respect to a securities acquisition loan (as defined in section 133(b)). Such interest shall not be included in life insurance gross income for purposes of subsection (b)(3)."

(i) TREATMENT OF FOREIGN LIFE INSURANCE COMPANIES.—Paragraph (1) of section 813(a) (relating to adjustment where surplus held in United States is less than speci-

fied minimum) is amended by adding at the end thereof the following new sentence: "The preceding sentence shall be applied before computing the amount of the special life insurance company deduction and the small life insurance company deduction, and any increase under the preceding sentence shall be treated as gross investment income."

(j) TREATMENT OF CERTAIN DISTRIBUTIONS TO SHAREHOLDERS FROM PRE-1984 POLICYHOLDERS SURPLUS ACCOUNT.—

(1) Subsection (f) of section 815 (relating to other rules applicable to policyholders surplus account continued) is amended by striking out "sections 6501(c)(6)" and inserting in lieu thereof "sections 819(b), 6501(c)(6)".

(2) Subsection (a) of section 815 is amended by adding at the end thereof the following new sentence: "For purposes of the preceding sentence, the term 'indirect distribution' shall not include any bona fide loan with arms-length terms and conditions."

(k) TREATMENT OF DEFICIENCY RESERVES.—Section 816 (defining life insurance company) is amended by adding at the end thereof the following new subsection:

"(h) TREATMENT OF DEFICIENCY RESERVES.—For purposes of this section and section 813(a)(4)(B), the terms

'life insurance reserves' and 'total reserves' shall not include deficiency reserves."

(l) TREATMENT OF CERTAIN NONDIVERSIFIED CONTRACTS.—

(1) Subsection (h) of section 817 (relating to treatment of certain nondiversified contracts) is amended by striking out paragraphs (3) and (4) and inserting in lieu thereof the following:

"(3) SPECIAL RULE FOR INVESTMENTS IN UNITED STATES OBLIGATIONS.—To the extent that any segregated asset account with respect to a variable life insurance contract is invested in securities issued by the United States Treasury, the investments made by such account shall be treated as adequately diversified for purposes of paragraph (1).

"(4) LOOK-THROUGH IN CERTAIN CASES.—For purposes of this subsection, if all of the beneficial interests in a regulated investment company or in a trust are held by 1 or more—

"(A) insurance companies (or affiliated companies) in their general account or in segregated asset accounts, or

"(B) fund managers (or affiliated companies) in connection with the creation or management of the regulated investment company or trust,

the diversification requirements of paragraph (1) shall be applied by taking into account the assets held by such regulated investment company or trust.

"(5) INDEPENDENT INVESTMENT ADVISORS PERMITTED.—Nothing in this subsection shall be construed as prohibiting the use of independent investment advisors."

(2) Paragraph (1) of section 817(h) is amended by striking out the last sentence.

(m) TREATMENT OF CERTAIN DEFERRED COMPENSATION PLANS.—Subparagraph (A) of section 818(a)(6) (defining pension plan contract) is amended to read as follows:

"(A) a governmental plan (within the meaning of section 414(d)) or an eligible State deferred compensation plan (within the meaning of section 457(b)), or".

(n) DIVIDENDS WITHIN AFFILIATED GROUP.—Subsection (e) of section 818 (relating to special rule for consolidated returns) is amended to read as follows:

"(e) SPECIAL RULES FOR CONSOLIDATED RETURNS.—

"(1) ITEMS OF COMPANIES OTHER THAN LIFE INSURANCE COMPANIES.—If an election under section 1504(c)(2) is in effect with respect to an affiliated group for the taxable year, all items of the members of

such group which are not life insurance companies shall not be taken into account in determining the amount of the tentative LICTI of members of such group which are life insurance companies.

"(2) DIVIDENDS WITHIN GROUP.—In the case of a life insurance company filing or required to file a consolidated return under section 1501 with respect to any affiliated group for any taxable year, any determination under this part with respect to any dividend paid by one member of such group to another member of such group shall be made as if such group was not filing a consolidated return."

(o) CLERICAL AMENDMENT.—Paragraph (3) of section 809(f) is amended by striking out "subsection (c)(2)" and inserting in lieu thereof "subsection (c)(1)(B)".

SEC. 122. AMENDMENTS RELATED TO SECTION 216 OF THE ACT.

(a) CLARIFICATION OF APPLICATION OF 10-YEAR SPREAD.—Subparagraph (C) of section 216(b)(3) of the Tax Reform Act of 1984 (relating to 10-year spread inapplicable where no 10-year spread under prior law) is amended by striking out "was required to have been taken into account" and inserting in lieu thereof "would have been required to be taken into account".

(b) TREATMENT OF CERTAIN ELECTIONS UNDER SECTION 818(c).—Subparagraph (B) of section 216(b)(4) of the Tax Reform Act of 1984 (relating to the elections under section 818(c) after September 27, 1983, not taken into account) is amended by striking out "Subparagraph (A)" and inserting in lieu thereof "Paragraph (3) and subparagraph (A) of this paragraph".

(c) ELECTION NOT TO HAVE RESERVES RECOMPUTED.—

(1) Clause (ii) of section 216(c)(2)(A) of the Tax Reform Act of 1984 (relating to election with respect to contracts issued after 1983 and before 1989) is amended by striking out "$3,000,000" and inserting in lieu thereof "$3,000,000 (determined with regard to this paragraph)".

(2) Subparagraph (B) of section 216(c)(2) of the Tax Reform Act of 1984 is amended—

(A) by striking out "statutory reserves" and inserting in lieu thereof "opening and closing statutory reserves", and

(B) by striking out "under section 805(c)(1) of such Code" and inserting in lieu thereof "under the principles of section 805(c)(1) of such Code".

(d) SPECIAL RULE WHERE REINSURER NOT USING CALENDAR YEAR AS TAXABLE YEAR.—Subparagraph (A)

of section 216(b)(3) of the Tax Reform Act of 1984 is amended by adding at the end thereof the following: "For purposes of this subparagraph, if the reinsurer's taxable year is not a calendar year, the first day of the reinsurer's first taxable year beginning after December 31, 1983, shall be substituted for 'January 1, 1984' each place it appears."

SEC. 123. AMENDMENT RELATED TO SECTION 217 OF THE ACT.

Subsection (n) of section 217 of the Tax Reform Act of 1984 (relating to special rule for companies using net level reserve method for noncancellable accident and health insurance contracts) is amended to read as follows:

"(n) SPECIAL RULE FOR COMPANIES USING NET LEVEL RESERVE METHOD FOR NONCANCELLABLE ACCIDENT AND HEALTH INSURANCE CONTRACTS.—A company shall be treated as meeting the requirements of section 807(d)(3)(A)(iii) of the Internal Revenue Code of 1954, as amended by this Act, with respect to any directly-written noncancellable accident and health insurance contract (whether under existing or new plans of insurance) for any taxable year if—

"(1) such company—

"(A) was using the net level reserve method to compute at least 99 percent of its statutory reserves on such contracts as of December 31, 1982, and

"(B) received more than half its total direct premiums in 1982 from directly-written noncancellable accident and health insurance,

"(2) after December 31, 1983, and through such taxable year, such company has continuously used the net level reserve method for computing at least 99 percent of its tax and statutory reserves on such contracts, and

"(3) for any such contract for which the company does not use the net level reserve method, such company uses the same method for computing tax reserves as such company uses for computing its statutory reserves."

SEC. 124. AMENDMENT RELATED TO SECTION 218 OF THE ACT.

Section 218 of the Tax Reform Act of 1984 is hereby repealed.

SEC. 125. AMENDMENTS RELATED TO SECTION 221 OF THE ACT.

(a) COMPUTATIONAL RULES.—Paragraph (1) of section 7702(e) (relating to computational rules) is amended —

(1) by striking out "shall be no earlier than" in subparagraph (B) and inserting in lieu thereof "shall be deemed to be no earlier than",

(2) by striking out "and" at the end of subparagraph (B),

(3) by redesignating subparagraph (C) as subparagraph (D) and inserting after subparagraph (B) the following new subparagraph:

"(C) the death benefits shall be deemed to be provided until the maturity date determined by taking into account subparagraph (B), and", and

(4) by striking out "the maturity date described in subparagraph (B)" in subparagraph (D) (as so redesignated) and inserting in lieu thereof "the maturity date determined by taking into account subparagraph (B)".

(b) TREATMENT OF FLEXIBLE PREMIUM CONTRACTS ISSUED DURING 1984 WHICH MEET NEW REQUIREMENTS.—Subsection (b) of section 221 of the Tax Reform Act of 1984 (relating to 1-year extension of flexible premium contract provisions) is amended by adding at the end thereof the following new paragraph:

"(3) TRANSITIONAL RULE.—Any flexible premium contract issued during 1984 which meets the requirements of section 7702 of the Internal Revenue Code of 1954 (as added by this section) shall be treated as meeting the requirements of section 101(f) of such Code."

(c) TREATMENT OF CERTAIN CONTRACTS ISSUED BEFORE OCTOBER 1, 1984.—Clause (i) of section

221(d)(2)(C) of the Tax Reform Act of 1984 (relating to certain contracts issued before October 1, 1984) is amended—

(1) by striking out "in clause (i) thereof" in the material preceding subclause (I), and

(2) by striking out "any mortality charges" in subclause (I) and inserting in lieu thereof "any mortality charges and any initial excess interest guarantees".

SEC. 126. AMENDMENTS RELATED TO SECTION 222 OF THE ACT.

(a) EXCEPTION FOR ANNUITY CONTRACTS WHICH ARE PART OF QUALIFIED PLANS.—Subsection (s) of section 72 (relating to required distributions where holder dies before entire interest is distributed) is amended by adding at the end thereof the following new paragraph:

"(5) EXCEPTION FOR ANNUITY CONTRACTS WHICH ARE PART OF QUALIFIED PLANS.—This subsection shall not apply to any annuity contract—

"(A) which is purchased—

"(i) by a trust described in section 401(a) which is exempt from tax under section 501, or

"(ii) as part of a plan described in section 403(a),

"(B) which is described in section 403(b), or

"(C) which is an individual retirement annuity or purchased under an individual retirement account or annuity."

(b) SPECIAL RULES WHERE HOLDER IS NOT INDIVIDUAL, ETC.—

(1) Subsection (s) of section 72 (relating to required distributions where holder dies before entire interest is distributed) is amended by adding at the end thereof the following new paragraphs:

"(6) SPECIAL RULE WHERE HOLDER IS CORPORATION OR OTHER NON-INDIVIDUAL.—

"(A) IN GENERAL.—For purposes of this subsection, if the holder of the contract is not an individual, the primary annuitant shall be treated as the holder of the contract.

"(B) PRIMARY ANNUITANT.—For purposes of subparagraph (A), the term 'primary annuitant' means the individual, the events in the life of whom are of primary importance in affecting the timing or amount of the payout under the contract.

"(7) TREATMENT OF CERTAIN TRANSFERS.—

"(A) IN GENERAL.—For purposes of this subsection, if—

"(i) an individual who holds an annuity contract transfers it by gift, or

"(ii) in the case of a holder which is not an individual, there is any change in a primary annuitant (as defined in paragraph (6)(B)),

then such transfer or change shall be treated as the death of the holder.

"(B) EXCEPTION FOR CERTAIN TRANSFERS BETWEEN SPOUSES OR FORMER SPOUSES.—Subparagraph (A) shall not apply to any transfer to which section 1041(a) (relating to transfers of property between spouses or incident to divorce) applies."

(2) Paragraph (1) of section 72(s) is amended by striking out "the holder of such contract" each place it appears and inserting in lieu thereof "any holder of such contract".

(3) The amendments made by this subsection shall apply to contracts issued after the date which is 6 months after the date of the enactment of this Act in taxable years ending after such date.

(c) CLARIFICATION OF EXCEPTION FOR DISTRIBUTION AFTER DEATH.—Subparagraph (B) of section 72(q)(2)

(relating to 5-percent penalty for premature distributions from annuity contracts) is amended to read as follows:

"(B) made on or after the death of the holder (or, where the holder is not an individual, the death of the primary annuitant (as defined in subsection (s)(6)(B))),".

SEC. 127. AMENDMENTS RELATED TO SECTION 223 OF THE ACT.

(a) DETERMINATION OF COSTS IN THE CASE OF DISCRIMINATORY PLANS.—

(1) IN GENERAL.—Subparagraph (B) of section 79(d)(1) (relating to nondiscrimination requirements) is amended to read as follows:

"(B) the cost of group-term life insurance on the life of any key employee shall be the greater of—

"(i) such cost determined without regard to subsection (c), or

"(ii) such cost determined with regard to subsection (c)."

(2) EFFECTIVE DATE.—The amendment made by paragraph (1) shall apply to taxable years ending after the date of the enactment of this Act.

(b) CLARIFICATION OF EFFECTIVE DATE.—Subparagraph (A) of section 223(d)(2) of the Tax Reform Act of 1984

(relating to treatment of former employees in case of existing group-term insurance plans) is amended by striking out the material following clause (ii) and inserting in lieu thereof the following:

"but only with respect to an individual who attained age 55 on or before January 1, 1984, and was employed by such employer (or a predecessor employer) at any time during 1983. Such amendments also shall not apply to any employee who retired from employment on or before January 1, 1984, and who, when he retired, was covered by the plan (or a predecessor plan)."

(c) DEFINITION OF KEY EMPLOYEE.—Paragraph (6) of section 79(d) (defining key employee) is amended by adding at the end thereof the following new sentence: "Such term also includes any retired employee if such employee when he retired was a key employee."

(d) SEPARATE TREATMENT OF FORMER EMPLOYEES.—Subsection (d) of section 79 (relating to nondiscrimination requirements) is amended by adding at the end thereof the following new paragraph:

"(8) TREATMENT OF FORMER EMPLOYEES.—To the extent provided in regulations, this subsection shall be applied separately with respect to former employees."

(e) COORDINATION WITH SECTION 83.—Paragraph (5) of section 83(e) is amended by striking out "the cost of".

SEC. 128. AMENDMENT RELATED TO SECTION 224 OF THE ACT.

Paragraph (1) of section 1035(b) (defining endowment contract) is amended by striking out "subject to tax under subchapter L".

SEC. 129. WAIVER OF INTEREST ON CERTAIN UNDERPAYMENTS OF TAX.

No interest shall be payable for any period before July 19, 1984, on any underpayment of a tax imposed by the Internal Revenue Code of 1954, to the extent such underpayment was created or increased by any provision of subtitle A of title II of the Tax Reform Act of 1984 (relating to taxation of life insurance companies).

PART C—AMENDMENTS RELATED TO TITLE III OF THE ACT

SEC. 131. AMENDMENT RELATED TO SECTION 301 OF THE ACT.

Clause (iv) of section 170(b)(1)(C) (defining capital gain property) is amended by striking out "this subparagraph" and inserting in lieu thereof "this paragraph".

SEC. 132. AMENDMENT RELATED TO SECTION 303 OF THE ACT.

Paragraph (2) of section 4940(e) (relating to requirements) is amended by striking out subparagraph (B) and the material following such subparagraph and inserting in lieu thereof the following:

"(B) such private foundation was not liable for tax under section 4942 with respect to any year in the base period."

SEC. 133. AMENDMENT RELATED TO SECTION 311 OF THE ACT.

Subparagraph (A) of section 311(a)(3) of the Tax Reform Act of 1984 is amended by striking out "a State law" and inserting in lieu thereof "a State law (originally enacted on April 22, 1977)".

PART D—AMENDMENTS RELATED TO TITLE IV OF THE ACT

SEC. 141. AMENDMENT RELATED TO SECTION 411 OF THE ACT.

Section 6654 (relating to failure by individual to pay estimated income tax) is amended by redesignating subsections (j), (k), and (l) as subsections (k), (l), and (m), respectively, and by inserting after subsection (i) the following new subsection:

"(j) SPECIAL RULES FOR NONRESIDENT ALIENS.—In the case of a nonresident alien described in section 6072(c):

"(1) PAYABLE IN 3 INSTALLMENTS.—There shall be 3 required installments for the taxable year.

"(2) TIME FOR PAYMENT OF INSTALLMENTS.—The due dates for required installments under this subsection shall be determined under the following table:

"In the case of the following required installments:	The due date is:
1st	June 15
2nd	September 15

3rd	January 15 of the following taxable year.

"(3) AMOUNT OF REQUIRED INSTALLMENTS.—

"(A) FIRST REQUIRED INSTALLMENT.—In the case of the first required installment, subsection (d) shall be applied by substituting '50 percent' for '25 percent' in subsection (d)(1)(A).

"(B) DETERMINATION OF APPLICABLE PERCENTAGE.—The applicable percentage for purposes of subsection (d)(2) shall be determined under the following table:

"In the case of the following required installments:	The applicable percentage is:
1st	40
2nd	60
3rd	80."

SEC. 142. AMENDMENT RELATED TO SECTION 421 OF THE ACT.

Section 267 (relating to losses, expenses, and interest with respect to transactions between related taxpayers) is amended by adding at the end thereof the following new subsection:

"(g) COORDINATION WITH SECTION 1041.—Subsection (a)(1) shall not apply to any transfer described in section 1041(a) (relating to transfers of property between spouses or incident to divorce)."

SEC. 143. AMENDMENTS RELATED TO SECTION 422 OF THE ACT.

(a) CROSS REFERENCE.—Section 71 (relating to alimony and separate maintenance payments) is amended by adding at the end thereof the following new subsection:

"(g) CROSS REFERENCES.—

"(1) For deduction of alimony or separate maintenance payments, see section 215.

"(2) For taxable status of income of an estate or trust in the case of divorce, etc., see section 682."

(b) CLERICAL AMENDMENT.—Subparagraph (B) of section 71(c)(2) (relating to treatment of certain reductions related to contingency involving child) is amended by striking out "specified in paragraph (1)" and inserting in lieu thereof "specified in subparagraph (A)".

SEC. 144. AMENDMENTS RELATED TO SECTION 431 OF THE ACT.

(a) DEFINITION OF RELATED PERSON.—Clause (v) of section 46(c)(8)(D) is amended by striking out "clause (i)" and inserting in lieu thereof "this subparagraph".

(b) CLARIFICATION OF RECAPTURE.—

(1) Paragraph (1) of section 47(d) (relating to increases in nonqualified nonrecourse financing) is amended by striking out "reducing the qualified investment" and inserting in lieu thereof "reducing the credit base (as defined in section 48(c)(8)(C))".

(2) Subparagraph (F) of section 47(d)(3) (relating to application with subsection (a)) is amended by striking out "the qualified investment" and inserting in lieu thereof "the credit base determined".

SEC. 145. AMENDMENT RELATED TO SECTION 452 OF THE ACT.

Section 456 of the Tax Reform Act of 1984 is amended by adding at the end thereof the following new subsection:

"(d) SECTION 452.—The amendment made by section 452 shall apply to products manufactured or produced after October 31, 1984."

SEC. 146. AMENDMENTS RELATED TO SECTION 473 OF THE ACT.

Subsection (d) of section 39 (relating to transitional rules) is amended—

(1) by striking out "or 44G" in paragraph (1)(A) and inserting in lieu thereof "or 44G (as in effect before the enactment of the Tax Reform Act of 1984)", and

(2) by striking out "as so defined in section 25(b)" in paragraph (2)(B) and inserting in lieu thereof "as defined in section 26(b)".

SEC. 147. AMENDMENTS RELATED TO SECTION 474 OF THE ACT.

(a) MINIMUM TAX AMENDMENTS.—

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(1) Subparagraph (A) of section 55(c)(3) (relating to carryover and carryback of certain credits) is amended by striking out "of such limitation" and inserting in lieu thereof "of such credit allowable".

(2) Effective with respect to taxable years beginning after December 31, 1982, clause (i) of section 55(c)(2)(E) (relating to special rule for applying section 904(c)) is amended to read as follows:

"(i) the limitation of section 904(a) shall be deemed to be the amount of foreign tax credit allowable under section 27(a) in computing the regular tax for the taxable year increased by the amount of the limitation determined under subparagraph (C), and".

(b) CLERICAL AMENDMENTS.—

(1) The clause heading for clause (iii) of section 30(b)(2)(D) is amended by striking out "NEW JOBS OR WIN CREDIT" and inserting in lieu thereof "TARGETED JOBS CREDIT".

(2) Paragraph (1) of section 86(f) is amended by striking out "section 37(c)(3)(A)" and inserting in lieu thereof "section 22(c)(3)(A)".

(3) Subparagraph (C) of section 151(e)(5) is amended by striking out "section 37(e)" and inserting in lieu thereof "section 22(e)".

(4) Clause (i) of section 415(c)(3)(C) is amended by striking out "section 37(e)(3)" and inserting in lieu thereof "section 22(e)(3)".

(5) Paragraph (9) of section 422A(c) is amended by striking out "section 37(e)(3)" and inserting in lieu thereof "section 22(e)(3)".

(6) Paragraph (5) of section 48(l) is amended—

(A) by striking out "section 44C(c)" and inserting in lieu thereof "section 23(c)", and

(B) by striking out "section 44C(c)(4)(A)(viii)" and inserting in lieu thereof "section 23(c)(4)(A)(viii)".

(7) Subparagraph (E) of section 108(b)(2) is amended by striking out "section 33" and inserting in lieu thereof "section 27".

(8) Subsection (b) of section 280C is amended—

(A) by striking out "section 29" each place it appears and inserting in lieu thereof "section 28", and

(B) by striking out "section 29(b)" and inserting in lieu thereof "section 28(b)".

(9) Section 6699 is amended—

(A) by striking out "section 44G" each place it appears in subsections (a) and (c)(2)(B) and inserting in lieu thereof "section 41", and

(B) by striking out "section 44G(c)(1)(B)" in subsection (a)(4) and inserting in lieu thereof "section 41(c)(1)(B)".

(10) Subsection (a) of section 6411 is amended by striking out "or unused business credit" in the second sentence thereof and inserting in lieu thereof "unused research credit, or unused business credit".

(11) Subparagraph (A) of section 46(b)(2) is amended by striking out "48(l)(3)(A)(vii)" in the table contained in such subparagraph and inserting in lieu thereof "48(l)(3)(A)(viii)".

(12) Paragraph (1) of section 163(b) of the Tax Reform Act of 1984 is amended by inserting "(as amended by sections 211, 314, and 474 of this Act)" after "Section 6501".

(13) Section 6501 is amended by redesignating subsection (n) as subsection (o) and by inserting after subsection (m) the following new subsection:

"(n) DEFICIENCIES ATTRIBUTABLE TO ELECTION OF CERTAIN CREDITS.—The period for assessing a deficiency attributable to any election under section 40(f) or 51(j) (or any revocation thereof) shall not expire before the date 1 year after the date on which the Secretary is notified of such election (or revocation)."

(14) Subsection (k) of section 6501 is amended by striking out "an investment credit carryback, or a work incentive program carryback, or a new employee credit carryback" and inserting in lieu thereof "or a credit carryback (as defined in section 6511(d)(4)(C))".

(15) Subsection (h) of section 6511 (relating to limitations on credit or refund) is amended—

(A) by striking out "section 6501(q)(1)(B)" in paragraph (1) and inserting in lieu thereof "section 6501(m)(1)(B)", and

(B) by striking out "section 6501(q)(2)(B)" in paragraph (2) and inserting in lieu thereof "section 6501(m)(2)(B)".

(16) Paragraph (1) of section 665(d) is amended by striking out "subpart A of part IV" and inserting in lieu thereof "part IV".

SEC. 148. AMENDMENTS RELATED TO SECTION 491 OF THE ACT.

(a) Paragraph (9) of section 46(f) (relating to special rule for additional credit) is hereby repealed.

(b) Subparagraph (A) of section 401(c)(2) (defining earned income) is amended by striking out "sections 404 and 405(c)" and inserting in lieu thereof "section 404".

(c) Subparagraph (d) of section 404(a)(8) is amended by striking out "the deductions allowed by this section and sec-

tion 405(c)" and inserting in lieu thereof "the deduction allowed by this section".

(d) The second sentence of section 2039(e) is amended by striking out "or a bond described in paragraph (3)".

PART E—AMENDMENTS RELATED TO TITLE V OF THE ACT

SEC. 151. AMENDMENTS RELATED TO WELFARE BENEFIT PLAN PROVISIONS.

(a) AMENDMENTS RELATED TO SECTION 511 OF THE ACT.—

(1) TREATMENT OF PLANS FOR INDEPENDENT CONTRACTORS.—Paragraph (1) of section 419(g) (relating to extension to plans for independent contractors) is amended by striking out "such a plan" and inserting in lieu thereof "such a relationship".

(2) AMENDMENTS TO SECTION 419A(d).—

(A) COORDINATION WITH SECTION 415.—Paragraph (2) of section 419A(d) (relating to coordination with section 415) is amended by adding at the end thereof the following new sentence: "Subparagraph (B) of section 415(c)(1) shall not apply to any amount treated as an annual addition under the preceding sentence."

(B) SEPARATE ACCOUNT REQUIREMENTS APPLY ONLY WHERE THERE IS PRE-FUNDING.—

Paragraph (1) of section 419A(d) is amended by adding at the end thereof the following new sentence:

"The requirements of this paragraph shall apply to the first taxable year for which a reserve is taken into account under subsection (c)(2) and to all subsequent taxable years."

(3) CLARIFICATION OF SECTION 419A(e).—

(A) Subsection (e) of section 419A is amended to read as follows:

"(e) SPECIAL LIMITATIONS ON RESERVES FOR MEDICAL BENEFITS OR LIFE INSURANCE BENEFITS PROVIDED TO RETIRED EMPLOYEES.—

"(1) RESERVE MUST BE NONDISCRIMINATORY.—No reserve may be taken into account under subsection (c)(2) for post-retirement medical benefits or life insurance benefits to be provided to covered employees unless the plan meets the requirements of section 505(b) with respect to such benefits (whether or not such requirements apply to such plan). The preceding sentence shall not apply to any plan maintained pursuant to an agreement between employee representatives and 1 or more employers if the Secretary finds that such agreement is a collective bargaining agreement and that post-retirement medical benefits or life insur-

ance benefits were the subject of good faith bargaining between such employee representatives and such employer or employers.

"(2) LIMITATION ON AMOUNT OF LIFE INSURANCE BENEFITS.—Life insurance benefits shall not be taken into account under subsection (c)(2) to the extent the aggregate amount of such benefits to be provided with respect to the employee exceeds $50,000."

(B) Paragraph (2) of section 419A(e) of the Internal Revenue Code of 1954 (as amended by subparagraph (A)) shall not apply to any group-term life insurance to the extent that the amendments made by section 223(a) of the Tax Reform Act of 1984 do not apply to such insurance by reason of paragraph (2) of section 223(d) of such Act.

(4) TREATMENT OF COLLECTIVELY BARGAINED PLANS.—Paragraph (5) of section 419A(f) (relating to higher limit in case of collectively bargained plans) is amended by striking out "welfare benefit fund established under" and inserting in lieu thereof "welfare benefit fund maintained pursuant to".

(5) CLARIFICATION OF ACTUARIAL CERTIFICATION REQUIREMENT.—Subparagraph (A) of section 419A(c)(5) (relating to special limitation where no ac-

tuarial certification) is amended by striking out "under paragraph (1)" and inserting in lieu thereof "under this subsection".

(6) AGGREGATION RULES.—Paragraph (1) of section 419A(h) (relating to aggregation rules) is amended to read as follows:

"(1) AGGREGATION OF FUNDS.—

"(A) MANDATORY AGGREGATION.—For purposes of subsections (c)(4), (d)(2), and (e)(2), all welfare benefit funds of an employer shall be treated as 1 fund.

"(B) PERMISSIVE AGGREGATION FOR PURPOSES NOT SPECIFIED IN SUBPARAGRAPH (A).—For purposes of this section (other than the provisions specified in subparagraph (A)), at the election of the employer, 2 or more welfare benefit funds of such employer may be treated as 1 fund."

(7) CLARIFICATION OF ADJUSTMENTS FOR EXISTING RESERVES.—Paragraph (7) of section 419A(f) (relating to adjustments for existing excess reserves) is amended by striking out subparagraph (C) and inserting in lieu thereof the following new subparagraphs:

"(C) EXISTING EXCESS RESERVE.—For purposes of computing the increase under sub-

paragraph (A) for any taxable year, the term 'existing excess reserve' means the excess (if any) of—

"(i) the amount of assets set aside at the close of the first taxable year ending after July 18, 1984, for purposes described in subsection (a), over

"(ii) the account limit determined under this section (without regard to this paragraph) for the taxable year for which such increase is being computed.

"(D) FUNDS TO WHICH PARAGRAPH APPLIES.—This paragraph shall apply only to a welfare benefit fund which, as of July 18, 1984, had assets set aside for purposes described in subsection (a)."

(8) CLARIFICATION OF FUND.—Subsection (e) of section 419 (defining welfare benefit funds) is amended by adding at the end thereof the following new paragraph:

"(4) TREATMENT OF AMOUNTS HELD PURSUANT TO CERTAIN INSURANCE CONTRACTS.—

"(A) IN GENERAL.—Notwithstanding paragraph (3)(C), the term 'fund' shall not include

amounts held by an insurance company pursuant to an insurance contract if—

"(i) there is no guarantee of a renewal of such contract, and

"(ii) other than insurance protection, the only payments to which the employer or employees are entitled are experience rated refunds or policy dividends which are not guaranteed and which are determined by factors other than the amount of welfare benefits paid to (or on behalf of) the employees of the employer or their beneficiaries.

"(B) LIMITATION.—In the case of any insurance contract described in subparagraph (A), subparagraph (A) shall not apply unless the amount of any experience rated refund or policy dividend payable to an employer with respect to a policy year is treated by the employer as received or accrued in the taxable year in which the policy year ends."

(9) CLARIFICATION OF TAXES PAID BY EMPLOYER ON INCOME OF CERTAIN WELFARE BENEFIT FUNDS.—Subsection (g) of section 419A (relating to employer taxed on income of welfare benefit funds in

certain cases) is amended by adding at the end thereof the following new paragraph:

"(3) COORDINATION WITH SECTION 419.—If any amount is included in the gross income of an employer for any taxable year under paragraph (1) with respect to any welfare benefit fund—

"(A) the amount of the tax imposed by this chapter which is attributable to the amount so included shall be treated as a contribution paid to such welfare benefit fund on the last day of such taxable year, and

"(B) the tax so attributable shall be treated as imposed on the fund for purposes of section 419(c)(4)(A)."

(10) AMENDMENTS TO TAX ON UNRELATED BUSINESS INCOME.—

(A) Clause (i) of section 512(a)(3)(E) is amended by striking out "determined under section 419A(c)" and inserting in lieu thereof "determined under section 419A (without regard to subsection (f)(6) thereof)".

(B) Subparagraph (E) of section 512(a)(3) is amended by striking out clause (ii) and by redesignating clauses (iii) and (iv) as clauses (ii) and (iii), respectively.

(C) Clause (ii) of section 512(a)(3)(E) (as redesignated by subparagraph (B)) is amended—

(i) by striking out "a existing reserve" in subclause (I) and inserting in lieu thereof "an existing reserve",

(ii) by striking out "reserve or post-retirement medical or life insurance benefit" in subclause (II) and inserting in lieu thereof "reserve for post-retirement medical or life insurance benefits", and

(iii) by striking out "as of the close of the last plan year ending before the date of the enactment of the Tax Reform Act of 1984" in subclause (II) and insert in lieu thereof "on July 18, 1984".

(D) Clause (iii) of section 512(a)(3)(E) (as redesignated by subparagraph (B)) is amended by striking out "paragraph shall not" and inserting in lieu thereof "subparagraph shall not".

(11) AMENDMENTS RELATED TO TAX ON CERTAIN FUNDED WELFARE BENEFIT PLANS.—Subsection (b) of section 4976 (defining disqualified benefit) is amended to read as follows:

"(b) DISQUALIFIED BENEFIT.—For purposes of subsection (a)—

"(1) IN GENERAL.—The term 'disqualified benefit' means—

"(A) any post-retirement medical benefit or life insurance benefit provided with respect to a key employee if a separate account is required to be established for such employee under section 419A(d) and such payment is not from such account,

"(B) any post-retirement medical benefit or life insurance benefit provided with respect to an individual in whose favor discrimination is prohibited unless the plan meets the requirements of section 505(b) with respect to such benefit (whether or not such requirements apply to such plan), and

"(C) any portion of a welfare benefit fund reverting to the benefit of the employer.

"(2) EXCEPTION FOR COLLECTIVE BARGAINING PLANS.—Paragraph (1)(B) shall not apply to any plan maintained pursuant to an agreement between employee representatives and 1 or more employers if the Secretary finds that such agreement is a collective bargaining agreement and that the benefits referred to in paragraph (1)(B) were the subject of good faith bar-

gaining between such employee representatives and such employer or employers.

"(3) EXCEPTION FOR NONDEDUCTIBLE CONTRIBUTIONS.—Paragraph (1)(C) shall not apply to any amount attributable to a contribution to the fund which is not allowable as a deduction under section 419 for the taxable year or any prior taxable year (and such contribution shall not be included in any carryover under section 419(d)).

"(4) EXCEPTION FOR CERTAIN AMOUNTS CHARGED AGAINST EXISTING RESERVE.—Subparagraphs (A) and (B) of paragraph (1) shall not apply to post-retirement benefits charged against an existing reserve for post-retirement medical or life insurance benefits (as defined in section 512(a)(3)(E))."

(12) CLARIFICATION OF EFFECTIVE DATE.—Subsection (e) of section 511 of the Tax Reform Act of 1984 is amended by adding at the end thereof the following new paragraphs:

"(6) AMENDMENTS RELATED TO TAX ON UNRELATED BUSINESS INCOME.—The amendments made by subsection (b) shall apply with respect to taxable years ending after December 31, 1985. For purposes of section 15 of the Internal Revenue Code of 1954, such

amendments shall be treated as a change in the rate of a tax imposed by chapter 1 of such Code.

"(7) AMENDMENTS RELATED TO EXCISE TAXES ON CERTAIN WELFARE BENEFIT PLANS.—The amendments made by subsection (c) shall apply to benefits provided after December 31, 1985.

(13) CLERICAL AMENDMENT.—Paragraph (2) of section 511(e) of the Tax Reform Act of 1984 is amended by striking out "and section 514".

(b) AMENDMENTS RELATED TO SECTION 512 OF THE ACT.—

(1) Clause (ii) of section 404(b)(2)(B) (relating to exceptions for certain benefits) is amended by striking out "to any benefit" and inserting in lieu thereof "any benefit".

(2) Subsection (b) of section 404 is amended—

(A) by striking out "UNFUNDED" in the subsection heading and inserting in lieu thereof "CERTAIN", and

(B) by striking out "unfunded" in the heading of paragraph (2) and inserting in lieu thereof "certain".

(c) AMENDMENTS RELATED TO SECTION 513 OF THE ACT.—

(1) Paragraph (1) of section 505(a) (relating to certain requirements must be met in case of organizations described in paragraph (9) or (20) of section 501(c)) is amended by striking out "of an employer".

(2) Paragraph (1) of section 505(b) (relating to nondiscrimination requirements) is amended by striking out "as provided in paragraph (2)" and inserting in lieu thereof "as otherwise provided in this subsection".

(3) Subparagraph (B) of section 505(b)(1) is amended by striking out "highly compensated employees" and inserting in lieu thereof "highly compensated individuals".

(4) Paragraph (2) of section 505(a) (relating to exception for collective bargaining agreements) is amended to read as follows:

"(2) EXCEPTION FOR COLLECTIVE BARGAINING AGREEMENTS.—Paragraph (1) shall not apply to any organization which is part of a plan maintained pursuant to an agreement between employee representatives and 1 or more employers if the Secretary finds that such agreement is a collective bargaining agreement and that such plan was the subject of good faith bargaining between such employee representatives and such employer or employers."

SEC. 152. AMENDMENTS RELATED TO PENSION PLAN PROVISIONS.

(a) AMENDMENTS RELATED TO SECTION 521 OF THE ACT.—

(1) CLARIFICATION THAT DISTRIBUTION FROM INDIVIDUAL RETIREMENT ACCOUNTS OR ANNUITIES MUST BEGIN AT 70½.—

(A) Paragraph (6) of section 408(a) (defining individual retirement account) is amended by striking out "(relating to required distributions)" and inserting in lieu thereof "(without regard to subparagraph (C)(ii) thereof) and the incidental death benefit requirements of section 401(a)".

(B) Paragraph (3) of section 408(b) (defining individual retirement annuity) is amended by striking out "(relating to required distributions)" and inserting in lieu thereof "(without regard to subparagraph (C)(ii) thereof) and the incidental death benefit requirements of section 401(a)".

(2) EXEMPTION OF PRE-1985 ACCUMULATIONS FROM PENALTY ON PREMATURE DISTRIBUTIONS.—

(A) Subparagraph (A) of section 72(m)(5) (relating to penalties applicable to certain amounts received by 5-percent owners) is amended to read as follows:

"(A) This subparagraph shall apply—

"(i) to amounts which—

"(I) are received from a qualified trust described in section 401(a) or under a plan described in section 403(a), and

"(II) are received by a 5-percent owner before such owner attains the age of 59½ years, for any reason other than such owner becoming disabled (within the meaning of paragraph (7) of this section), and

"(ii) to amounts which are received from a qualified trust described in section 401(a) or under a plan described in section 403(a) at any time by a 5-percent owner, or by the successor of such owner, but only to the extent that such amounts are determined (under regulations prescribed by the Secretary) to exceed the benefits provided for such individual under the plan formula.

Clause (i) shall not apply to any amount received by an individual in his capacity as a policyholder of an annuity, endowment, or life insurance contract which is in the nature of a dividend or similar distribution and clause (i) shall not apply to

amounts attributable to contributions paid before January 1, 1985."

(B) Subparagraph (C) of section 72(m)(5) is amended to read as follows:

"(C) For purposes of this paragraph, the term '5-percent owner' means any individual who, at any time during the 5 plan years preceding the plan year in which the amount is received, is a 5-percent owner (as defined in section 416(i)(1)(B)."

(C) Paragraph (5) of section 72(m) is amended by striking out "OWNER-EMPLOYEES" in the paragraph heading and inserting in lieu thereof "5-percent owners".

(3) EXTENSION OF DISTRIBUTION REQUIREMENTS TO SECTION 403(b) ANNUITIES.—

(A) Subsection (b) of section 403 (relating to taxability of beneficiary under annuity purchased by section 501(c)(3) organization or public school) is amended by adding at the end thereof the following new paragraph:

"(10) DISTRIBUTION REQUIREMENTS.—Under regulations prescribed by the Secretary, this subsection shall not apply to any annuity contract (or to any custodial account described in paragraph (7) or retirement income account described in paragraph (9)) unless re-

quirements similar to the requirements of section 401(a)(9) are met (and requirements similar to the incidental death benefit requirements of section 401(a) are met) with respect to such annuity contract (or custodial account or retirement income account)."

(B) Paragraph (7) of section 403(b) is amended by striking out subparagraph (D).

(C) The amendments made by this paragraph shall apply to contributions made after the date of the enactment of this Act in taxable years ending after such date.

(4) CLARIFICATION OF REQUIRED BEGINNING DATE.—

(A) Subparagraph (C) of section 401(a)(9) (defining required beginning date) is amended by striking out the last sentence and inserting in lieu thereof the following:

"Clause (ii) shall not apply in the case of an employee who is a 5-percent owner (as defined in section 416(i)(1)(B)) at any time during the 5 plan years preceding the plan year ending in the calendar year in which the employee attains age 70½."

(B) Subsection (d) of section 409 (relating to employer securities must stay in the plan) is

amended by adding at the end thereof the following new sentence:

"This subsection shall not apply to any distribution required under section 401(a)(9)."

(5) REQUIRED DISTRIBUTIONS NOT ELIGIBLE FOR ROLLOVER TREATMENT.—

(A) Paragraph (5) of section 402(a) (relating to rollover amounts) is amended by adding at the end thereof the following new subparagraph:

"(G) REQUIRED DISTRIBUTIONS NOT ELIGIBLE FOR ROLLOVER TREATMENT.—Subparagraph (A) shall not apply to any distribution to the extent such distribution is required under section 401(a)(9)."

(B)(i) Subparagraph (B) of section 403(a)(4) is amended by striking out "and (F)" and inserting in lieu thereof "and (G)".

(ii) Paragraph (8) of section 403(b) is amended by adding at the end thereof the following new subparagraph:

"(D) REQUIRED DISTRIBUTIONS NOT ELIGIBLE FOR ROLLOVER TREATMENT.—Subparagraph (A) shall not apply to any distribution to the extent such distribution is required under paragraph (10)."

(C) Paragraph (3) of section 408(d) (relating to rollover contributions) is amended by adding at the end thereof the following new subparagraph:

"(E) DENIAL OF ROLLOVER TREATMENT FOR REQUIRED DISTRIBUTIONS.—This subparagraph shall not apply to any amount to the extent such amount is required to be distributed under subsection (a)(6) or (b)(3)."

(6) TREATMENT OF DISTRIBUTIONS REQUIRED UNDER INCIDENTAL DEATH BENEFIT RULES.—Paragraph (9) of section 401(a) (relating to required distributions) is amended by adding at the end thereof the following new subparagraph:

"(G) TREATMENT OF INCIDENTAL DEATH BENEFIT DISTRIBUTIONS.—For purposes of this title, any distribution required under the incidental death benefit requirements of this subsection shall be treated as a distribution required under this paragraph."

(7) CONFORMING AMENDMENTS TO SECTION 4974.—

(A) Subsection (a) of section 4974 (relating to excise tax on certain accumulations in individual retirement accounts or annuities) is amended by striking out "section 408(a) (6) or (7), or

408(b) (3) or (4)" and inserting in lieu thereof "section 408(a)(6) or 408(b)(3)".

(B) Subsection (b) of section 4974 is amended by striking out "section 408(a) (6) or (7) or 408(b) (3) or (4)" and inserting in lieu thereof "section 408(a)(6) or 408(b)(3)".

(b) AMENDMENTS RELATED TO SECTION 522 OF THE ACT.—

(1) Clause (v) of section 402(a)(5)(E) (defining partial distribution) is amended by striking out "of any portion of" and inserting in lieu thereof "of all or any portion of".

(2) Clause (i) of section 402(a)(5)(D) (relating to special rules for partial distributions) is amended by adding at the end thereof the following new sentence:

"For purposes of subclause (I), the balance to the credit of the employee shall not include any accumulated deductible employee contributions (within the meaning of section 72(o)(5))."

(3)(A) Section 402 is amended by adding at the end thereof the following new subsection:

"(g) TREATMENT OF SELF-EMPLOYED INDIVIDUALS.—For purposes of this section, except as otherwise provided in subparagraph (A) of subsection (e)(4), the term

'employee' includes a self-employed individual (as defined in section 401(c)(1)(B)) and the employer of such individual shall be the person treated as his employer under section 401(c)(4)."

(B) Paragraph (4) of section 402(e) is amended by striking out subparagraph (F).

(4) Paragraph (7) of section 402(a) (relating to rollover where spouse received distributions after death of employee) is amended by striking out "the spouse were the employee" and inserting in lieu thereof "the spouse were the employee; except that a trust or plan described in subclause (III) or (IV) of paragraph (5)(E)(iv) shall not be treated as an eligible retirement plan with respect to such distribution."

(5) Clause (ii) of section 402(a)(5)(D) is amended by striking out "a plan described in subclause (IV) or (V)" and inserting in lieu thereof "a trust or plan described in subclause (III) or (IV)".

(6) Clause (i) of section 402(a)(5)(F) is amended by striking out "a transfer described in subparagraph (A)" and inserting in lieu thereof "a transfer resulting in any portion of a distribution being excluded from gross income under subparagraph (A)".

(7) Paragraph (20) of section 401(a) is amended by striking out "qualifying rollover distribution (deter-

mined as if section 402(a)(5)(D)(i) did not contain subclause (II) thereof) described in section 402(a)(5)(A)(i) or 403(a)(4)(A)(i)" and inserting in lieu thereof "qualified total distribution described in section 402(a)(5)(E)(i)(I)".

(8) Subsection (e) of section 522 of the Tax Reform Act of 1984 is amended by striking out "the date of the amendment" and inserting in lieu thereof "the date of the enactment".

(9) Subparagraph (C) of section 403(b)(8) is amended by striking out "(F)(i)" and inserting in lieu thereof "and (F)(i)".

(c) AMENDMENTS RELATED TO SECTION 523 of the Act.—

(1) Subparagraph (B) of section 72(e)(7) (relating to plans substantially all the contributions of which are employee contributions) is amended—

(A) by striking out "any trust or contract" and inserting in lieu thereof "any plan or contract",

(B) by striking out "85 percent of" and inserting in lieu thereof "85 percent or more of", and

(C) by adding at the end thereof the following new sentence:

"For purposes of clause (ii), deductible employee contributions (as defined in subsection (o)(5)(A)) shall not be taken into account."

(2) Subparagraph (E) of section 72(q)(2) (relating to 5-percent penalty for premature distributions from annuity contracts) is amended by striking out "subsection (e)(5)(D)" and inserting in lieu thereof "subsection (e)(5)(D) (determined without regard to subsection (e)(7))".

(3) Subsection (f) of section 72 is amended—

(A) by striking out "subsection (d)(1)" and inserting in lieu thereof "subsections (d)(1) and (e)(7)", and

(B) by striking out "subsection (e)(1)(B)" and inserting in lieu thereof "subsection (e)(6)".

(4) Subparagraph (C) of section 72(m)(2) is amended—

(A) by striking out "3 years)" in subparagraph (B) and inserting in lieu thereof "3 years) and subsection (e)(7) (relating to plans where substantially all contributions are employee contributions)", and

(B) by striking out "subsection (e)(1)(B)" in subparagraph (C) and inserting in lieu thereof "subsection (e)(6)".

(5) Subsection (b) of section 402 is amended by striking out "section 72(e)(1)" and inserting in lieu thereof "section 72(e)(5)".

(d) AMENDMENTS RELATED TO SECTION 524 OF THE ACT.—

(1) Subparagraph (A) of section 416(i)(1) (defining key employee) is amended by adding at the end thereof the following new sentence: "Such term shall not include any officer or employee of an entity referred to in section 414(d) (relating to governmental plans)."

(2) Subparagraph (E) of section 416(g)(4) (relating to benefits not taken into account if employee not employed for last 5 years) is amended to read as follows:

"(E) BENEFITS NOT TAKEN INTO ACCOUNT IF EMPLOYEE NOT EMPLOYED FOR LAST 5 YEARS.—If any individual has not performed services for the employer maintaining the plan at any time during the 5-year period ending on the determination date, any accrued benefit for such individual (and the account of such individual) shall not be taken into account."

(e) AMENDMENTS RELATED TO SECTION 525 OF THE ACT.—

(1)(A) Subsection (c) of section 2039 (relating to exception of certain annuity interests created by community property laws) is hereby repealed.

(B) The amendment made by subparagraph (A) shall apply to estates of decedents dying after the date of the enactment of this Act.

(2)(A) Section 2517 (relating to certain annuities under qualified plans) is hereby repealed.

(B) The table of sections for subchapter B of chapter 12 is amended by striking out the item relating to section 2517.

(C) The amendments made by this paragraph shall apply to transfers after the date of the enactment of this Act.

(f) AMENDMENT RELATED TO SECTION 526 OF THE ACT.—Paragraph (2) of section 526(d) of the Tax Reform Act of 1984 is amended by striking out "paragraph (6)" and inserting in lieu thereof "paragraph (7)".

(g) AMENDMENTS RELATED TO SECTION 527 OF THE ACT.—

(1) Paragraph (3) of section 401(k) (relating to application of participation and discrimination standards) is amended by adding at the end thereof the following new subparagraph:

"(C) A cash or deferred arrangement shall be treated as meeting the requirements of subsection (a)(4) with respect to contributions if the requirements of subparagraph (A)(ii) are met."

(2) Subparagraph (A) of section 401(k)(3) is amended by striking out the last sentence and inserting in lieu thereof the following: "If an employee is a participant under 2 or more cash or deferred arrangements of the employer, for purposes of determining the deferral percentage with respect to such employee, all such cash or deferred arrangements shall be treated as 1 cash or deferred arrangement."

(3) Subparagraph (C) of section 401(k)(2) is amended by striking out "are nonforfeitable" and inserting in lieu thereof "is nonforfeitable".

(h) AMENDMENTS RELATED TO SECTION 528 OF THE ACT.—

(1) Subsection (h) of section 401 (relating to medical, etc., benefits for retired employees and their spouses and dependents) is amended—

(A) by striking out "5-percent owner" each place it appears in paragraph (6) and inserting in lieu thereof "key employee", and

(B) by striking out the last sentence and inserting in lieu thereof the following:

"For purposes of paragraph (6), the term 'key employee' means any employee, who at any time during the plan year or any preceding plan year during which contributions were made on behalf of such employee, is or was a key employee as defined in section 416(i)."

(2) Paragraph (1) of section 415(1) (relating to treatment of certain medical benefits) is amended by adding at the end thereof the following new sentence: "Subparagraph (B) of subsection (c)(1) shall not apply to any amount treated as an annual addition under the preceding sentence."

(3) Subsection (l) of section 415 is amended by striking out "a defined benefit plan" each place it appears and inserting in lieu thereof "a pension or annuity plan".

SEC. 153. AMENDMENTS RELATED TO FRINGE BENEFIT PROVISIONS.

(a) AMENDMENTS TO SECTION 132.—

(1) Clause (ii) of section 132(f)(2)(B) (defining dependent children) is amended by striking out "are deceased" and inserting in lieu thereof "are deceased and who has not attained age 25".

(2) Subparagraph (A) of section 132(c)(3) (defining employee discount) is amended by striking out "are provided to the employee by the employer" and insert-

ing in lieu thereof "are provided by the employer to an employee for use by such employee".

(3) Subsection (i) of section 132 (relating to customers not to include employees) is amended by striking out "subsection (c)(2)(B)" and inserting in lieu thereof "subsection (c)(2)".

(b) AMENDMENTS TO SECTION 125.—

(1) CLARIFICATION OF BENEFITS WHICH MAY BE PROVIDED UNDER CAFETERIA PLANS.—

(A) Subsections (c) and (d)(1)(B) of section 125 are each amended by striking out "statutory nontaxable benefits" each place it appears and inserting in lieu thereof "qualified benefits".

(B) Subsection (f) of section 125 is amended to read as follows:

"(f) QUALIFIED BENEFITS DEFINED.—For purposes of this section, the term 'qualified benefit' means any benefit which, with the application of subsection (a), is not includible in the gross income of the employee by reason of an express provision of this chapter (other than section 117, 124, 127, or 132). Such term includes any group term life insurance which is includible in gross income only because it exceeds the dollar limitation of section 79 and such term includes any other benefit permitted under regulatons."

(2) TRANSITIONAL RULE.—Paragraph (5) of section 531(b) of the Tax Reform Act of 1984 (relating to exception for certain cafeteria plans and benefits) is amended by adding at the end thereof the following new subparagraph:

"(D) COLLECTIVE BARGAINING AGREEMENTS.—In the case of any cafeteria plan in existence on February 10, 1984, and maintained pursuant to 1 or more collective bargaining agreements between employee representatives and 1 or more employers, the date on which the last of such collective bargaining agreements terminates (determined without regard to any extension thereof agreed to after July 18, 1984) shall be substituted for 'January 1, 1985' in subparagraph (A) and for 'July 1, 1985' in subparagraph (B). For purposes of the preceding sentence, any plan amendment made pursuant to a collective bargaining agreement relating to the plan which amends the plan solely to conform to any requirement added by this section (or any requirement in the regulations under section 125 of the Internal Revenue Code of 1954 proposed on May 6, 1984) shall not be treated as a termination of such collective bargaining agreement."

(3) SPECIAL RULE WHERE CONTRIBUTIONS OR REIMBURSEMENTS SUSPENDED.—Paragraph (5) of section 531(b) of the Tax Reform Act of 1984 is amended by adding at the end thereof the following new subparagraph:

"(E) SPECIAL RULE WHERE CONTRIBUTIONS OR REIMBURSEMENTS SUSPENDED.—For purposes of subparagraphs (A) and (B), a plan shall not be treated as not continuing to fail to satisfy the rules referred to in such subparagraphs with respect to any benefit provided in the form of a flexible spending arrangement merely because contributions or reimbursements (or both) with respect to such plan were suspended before January 1, 1985."

(c) AMENDMENTS TO SECTION 4977.—

(1) Paragraph (2) of section 4977(c) is amended to read as follows:

"(2) at all times on or after January 1, 1984, and before the close of the calendar year involved, substantially all of the employees of the employer were entitled to employee discounts on goods or services provided by the employer in 1 line of business,".

(2) Section 4977 (relating to tax on certain fringe benefits provided by an employer) is amended by adding at the end thereof the following new subsection:

"(f) SECTION TO APPLY ONLY TO EMPLOYMENT WITHIN THE UNITED STATES.—Except as otherwise provided in regulations, this section shall apply only with respect to employment within the United States."

(d) TREATMENT OF TELEPHONE CONCESSION SERVICE FOR CERTAIN RETIREES.—Section 559 of the Tax Reform Act of 1984 is amended by adding at the end thereof the following subsection:

"(e) TELEPHONE SERVICE FOR PRE-DIVESTITURE RETIREES.—In the case of an employee who, by reason of retirement or disability, separated before January 1, 1984, from the service of an entity subject to the modified final judgment—

"(1) all entities subject to the modified final judgment shall be treated as a single employer in the same line of business for purposes of determining whether telephone service provided to the employee is a no-additional-cost service as defined in section 132 of the Internal Revenue Code of 1954; and

"(2) payment by an entity subject to the modified final judgment of all or part of the cost of local telephone service provided to the employee by a person

other than an entity subject to the modified final judgment (including rebate of the amount paid by the employee for the service and payment to the person providing the service) shall be treated as telephone service provided to the employee by such single employer for purposes of determining whether the telephone service is a no-additional-cost service as defined in section 132 of the Internal Revenue Code of 1954.

For purposes of this subsection, the term 'employee' has the meaning given to such term by section 132(f) of the Internal Revenue Code of 1954."

SEC. 154. AMENDMENTS RELATED TO EMPLOYEE STOCK OWNERSHIP PLANS.

(a) AMENDMENTS RELATED TO SECTION 541.—

(1) Section 1042(a) (relating to nonrecognition of gain) is amended by striking out "gain (if any) on such sale" and inserting in lieu thereof "gain (if any) on such sale which would be recognized as long-term capital gain".

(2) Section 1042(b)(2) (relating to requirement that employees must own 30 percent of stock after sale) is amended by striking out "the employer securities (within the meaning of section 409(1))" and inserting in lieu thereof "all stock (other than preferred

stock described in section 1504(a)(4)) of the corporation which issued the qualified securities".

(3) Paragraph (3) of section 1042(b) (relating to requirement that plan be maintained for benefit of employees) is amended to read as follows:

"(3) PLAN MAINTAINED FOR BENEFIT OF EMPLOYEES.—No portion of the assets of the plan or cooperative attributable to qualified securities with respect to which an election under subsection (a)(1) was made may accrue directly or indirectly under such plan, or may be allocated directly or indirectly by such cooperative, for the benefit of—

"(A) the taxpayer,

"(B) any person who bears a relationship to the taxpayer described in section 267(b), or

"(C) any other person who owns (after application of section 318(a)) more than 25 percent (by value) of—

"(i) any class of stock of the corporation which issued such qualified securities, or

"(ii) the total value of the stock of any other corporation which is a member of the same controlled group of corporations (within the meaning of section 409(l)(4)) as such corporation.

All plans which are treated as 1 plan under section 401(a)(4) or 410 shall be treated as 1 plan for purposes of this paragraph."

(4) Section 1042(c)(1) (defining qualified securities) is amended—

(A) by striking out "securities" in subparagraph (A) and inserting in lieu thereof "stock",

(B) by inserting "and" at the end of subparagraph (A), and

(C) by striking out subparagraph (B) and redesignating subparagraph (C) as subparagraph (B).

(5) Paragraph (4) of section 1042(c) (defining qualified replacement property) is amended to read as follows:

"(4) QUALIFIED REPLACEMENT PROPERTY.—

"(A) IN GENERAL.—The term 'qualified replacement property' means any security issued by a domestic operating corporation which—

"(i) did not, for the taxable year preceding the taxable year in which such security was purchased, have passive investment income (as defined in section 1362(d)(3)(D)) in excess of 25 percent of the gross receipts of such corporation for such preceding taxable year, and

"(ii) is not the corporation which issued the qualified securities which such security is replacing.

"(B) OPERATING CORPORATION.—For purposes of this paragraph, the term 'operating corporation' means a corporation substantially all the assets of which were, at the time the security was purchased, used in the active conduct of a trade or business.

"(C) CONTROLLING AND CONTROLLED CORPORATIONS TREATED AS 1 CORPORATION.—

"(i) IN GENERAL.—For purposes of applying this paragraph, if—

"(I) the corporation issuing the security owns stock representing control of 1 or more other corporations,

"(II) 1 or more other corporations own stock representing control of the corporation issuing the security, or

"(III) both,

then all such corporations shall be treated as 1 corporation.

"(ii) CONTROL.—For purposes of clause (i), the term 'control' has the meaning given such term by section 304(c).

"(D) SECURITY DEFINED.—For purposes of this paragraph, the term 'security' has the meaning given such term by section 165(g)(2), except that such term shall not include any security issued by a government or political subdivision thereof."

(6)(A) Section 1042(c) (relating to definitions and special rules) is amended by adding at the end thereof the following new paragraph:

"(7) SECTION NOT TO APPLY TO GAIN OF C CORPORATION.—Subsection (a) shall not apply to any gain on the sale of any qualified securities which is includible in the gross income of any C corporation."

(B) The amendment made by subparagraph (A) shall apply to sales after March 28, 1985, except that such amendment shall not apply to sales made before July 1, 1985, if made pursuant to a binding contract in effect on March 28, 1985, and at all times thereafter.

(7) Section 1042(d) (relating to basis of qualified replacement property) is amended by adding at the end thereof the following new flush sentence:

"Any reduction in basis under this subsection shall not be taken into account for purposes of section 1278(a)(2)(A)(ii) (relating to definition of market discount)."

(8)(A) Section 1042 is amended by redesignating subsection (e) as subsection (f) and by inserting after subsection (d) the following new subsection:

"(e) RECAPTURE OF GAIN ON DISPOSITION OF QUALIFIED REPLACEMENT PROPERTY.—

"(1) IN GENERAL.—If a taxpayer disposes of any qualified replacement property, then, notwithstanding any other provision of this title, gain (if any) shall be recognized to the extent of the gain which was not recognized under subsection (a) by reason of the acquisition by such taxpayer of such qualified replacement property.

"(2) SPECIAL RULE FOR CORPORATIONS CONTROLLED BY THE TAXPAYER.—If—

"(A) a corporation issuing qualified replacement property disposes of a substantial portion of its assets other than in the ordinary course of its trade or business, and

"(B) any taxpayer owning stock representing control (within the meaning of section 304(c)) of such corporaion at the time of such disposition holds any qualified replacement property of such corporation at such time,

then the taxpayer shall be treated as having disposed of such qualified replacement property at such time."

(B) The amendment made by subparagraph (A) shall apply to dispositions after the date of the enactment of this Act, in taxable years ending after such date.

(9) Paragraph (5) of section 1042(c) (relating to securities acquired by underwriter) is amended—

(A) by striking out "acquisition" and inserting in lieu thereof "sale",

(B) by inserting "to an employee stock ownership plan or eligible worker-owned cooperative" before "in", and

(C) by striking out "ACQUIRED" in the heading thereof and inserting in lieu thereof "SOLD".

(10) The heading for section 1042 is amended by inserting **"EMPLOYEE"** before **"STOCK".**

(11) The table of sections for part III of subchapter O of chapter 1 is amended by striking out the item relating to section 1042 and inserting in lieu thereof the following new item:

"Sec. 1042. Sales of stock to employee stock ownership plans or certain cooperatives."

(b) AMENDMENTS RELATED TO SECTION 542.—

(1) Paragraph (5) of section 72(e) is amended by adding at the end of subparagraph (D) the following new flush sentence:

"Clause (i) shall not apply to any dividend described in section 404(k) which is received by a participant."

(2) Paragraph (1) of section 404(k) (relating to dividends paid deduction) is amended by inserting ", and allocated to a participant's account," before "on the record date".

(3) Section 404(k) is amended—

(A) by adding at the end thereof the following new flush sentence:

"Any deduction under this subsection shall be allowed in the taxable year of the corporation in which the dividend is paid or distributed to the participant under paragraph (2).", and

(B) by striking out "during the taxable year" in the matter preceding paragraph (1).

(4) Section 404(k), as amended by paragraph (3), is amended by adding at the end thereof the following new sentence: "A plan to which this subsection applies shall not be treated as violating the requirements of section 401, 409, or 4975(e)(7) merely by reason of any distribution described in paragraph (2)."

(5) The amendments made by paragraphs (1) and (3) shall apply to dividends paid after the date of the enactment of this Act, in taxable years ending after such date.

(c) AMENDMENTS RELATED TO SECTION 543.—

(1) Subparagraph (B) of section 291(e)(1) (defining financial institution preference item) is amended by adding at the end thereof the following new clause:

"(iv) SPECIAL RULES FOR OBLIGATIONS TO WHICH SECTION 133 APPLIES.—In the case of an obligation to which section 133 applies—

"(I) interest on such obligations shall not be treated as exempt from taxes for purposes of this subparagraph, and

"(II) such obligation shall not be taken into account under clause (ii)(II)."

(2) Section 133 (relating to exemption for interest on certain loans used to acquire employer securities) is amended by adding at the end thereof the following new subsection:

"(d) APPLICATION WITH SECTION 483 AND ORIGINAL ISSUE DISCOUNT RULES.—In applying section 483 and subpart A of part V of subchapter P to any obligation to which this section applies, appropriate adjustments shall be made to the applicable Federal rate to take into account the exclusion under subsection (a)."

(d) AMENDMENTS RELATED TO SECTION 544.—

(1) Section 2210(a) (relating to liability for payment of estate tax in case of transfer of employer securities to an ESOP or worker cooperative) is amended by striking out "and" at the end of paragraph (1), by redesignating paragraph (2) as paragraph (3), and by inserting after paragraph (1) the following new paragraph:

"(2) the executor of the estate of the decedent may (without regard to this section) make an election under section 6166 with respect to that portion of the tax imposed by section 2001 which is attributable to employer securities, and".

(2) Section 2210(c) (relating to installment payments) is amended by adding at the end thereof the following new paragraph:

"(3) SPECIAL RULES FOR APPLICATION OF SECTION 6166(g).—In the case of any transfer of employer securities to an employee stock ownership plan or eligible worker-owner cooperative to which this section applies—

"(A) TRANSFER DOES NOT TRIGGER ACCELERATION.—Such transfer shall not be treated as a disposition or withdrawal to which section 6166(g) applies.

"(B) SEPARATE APPLICATION TO ESTATE AND PLAN INTERESTS.—Section 6166(g) shall be applied separately to the interests held after such transfer by the estate and such plan or cooperative.

"(C) REQUIRED DISTRIBUTION NOT TAKEN INTO ACCOUNT.—In the case of any distribution of such securities by such plan which is described in section 4978(d)(1)—

"(i) such distribution shall not be treated as a disposition or withdrawal for purposes of section 6166(g), and

"(ii) such securities shall not be taken into account in applying section 6166(g) to any subsequent disposition or withdrawal."

(3) Section 2210(g) (relating to definitions) is amended by adding at the end thereof the following new paragraph:

"(5) TAX IMPOSED BY SECTION 2001.—The term 'tax imposed by section 2001' includes any interest, penalty, addition to tax, or additional amount relating to any tax imposed by section 2001."

(4) Section 2210(c)(1) is amended by inserting "or any authorized officer of" before "the cooperative" in the matter following subparagraph (B).

(5) Section 2210(d) (relating to guarantee of payments) is amended—

(A) by inserting "and any eligible worker-owned cooperative" before "shall guarantee" in the matter following paragraph (2),

(B) by striking out "such plan" and inserting in lieu thereof "such plan or cooperative, respectively,", and

(C) by striking out ", including any interest payable under section 6601 which is attributable to such amount".

(6) Section 2210(g)(3) is amended by striking out "section 1041(b)(2)" and inserting in lieu thereof "section 1042(b)(2)".

(e) AMENDMENTS RELATED TO SECTION 545.—

(1) Section 4978(a)(1) (relating to tax on disposition of securities to which section 1042 applies before close of minimum holding period) is amended by striking out "then" and inserting in lieu thereof "than".

(2) Section 4978(b)(1) is amended by striking out "paragraph (1)" and inserting in lieu thereof "subsection (a)".

(3) Section 4978(c) is amended by striking out "section 1042(a)(2)(B)" and inserting in lieu thereof "section 1042(b)(4)".

(4) Section 4978(d)(1)(C) is amended by striking out "section 72(m)(5)" and inserting in lieu thereof "section 72(m)(7)".

(5) Section 4978(e)(2) is amended by striking out "section 1042(b)(1)" and inserting in lieu thereof "section 1042(c)(1)".

(6) Section 4978(e)(3) is amended by striking out "section 1042(b)(1)" and inserting in lieu thereof "section 1042(c)(2)".

(7) Section 4978(d) (relating to dispositions to which section does not apply) is amended by adding at the end thereof the following new paragraph:

"(3) LIQUIDATION OF CORPORATION INTO COOPERATIVE.—In the case of any exchange of qualified securities pursuant to the liquidation of the corporation issuing qualified securities into the eligible worker-owned cooperative in a transaction which meets the requirements of section 332 (determined by substituting '100 percent' for '80 percent' each place it appears in section 332(b)(1)), such exchange shall not be treated as a disposition for purposes of this section."

SEC. 155. AMENDMENT RELATED TO MISCELLANEOUS EMPLOYEE BENEFIT PROVISIONS.

Subsection (c) of section 555 of the Tax Reform Act of 1984 (relating to technical amendments to the incentive stock option provisions) is amended—

(1) by striking out "subsection (a)" in paragraph (1) and inserting in lieu thereof "subsection (a)(1)",

(2) by striking out "subsection (b)" in paragraph (2) and inserting in lieu thereof "subsection (a)(2)",

(3) by striking out "after March 20, 1984," in paragraph (2), and

(4) by striking out "subsection (c)" in paragraph (3) and inserting in lieu thereof "subsection (b)".

PART F—AMENDMENTS RELATED TO TITLE VI OF THE ACT

SEC. 161. AMENDMENTS RELATED TO SECTION 611 OF THE ACT.

(a) EXTENSION OF TIME FOR SUBMITTING POLICY STATEMENT.—Paragraph (5) of section 103A(j) is amended by adding at the end thereof the following new subparagraph:

"(C) EXTENSION OF TIME.—The Secretary may grant an extension of time for the publishing of a report described in subparagraph (B) or the submittal of such report to the Secretary if there is reasonable cause for the failure to publish or submit such report in a timely fashion."

(b) DEFINITION OF QUALIFIED VETERAN.—Subparagraph (B) of section 103A(o)(4) (defining qualified veteran) is amended by striking out "January 1, 1985" and inserting in lieu thereof "January 31, 1985".

SEC. 162. AMENDMENT RELATED TO SECTION 612 OF THE ACT.

(a) REQUIREMENTS FOR QUALIFIED MORTGAGE CREDIT CERTIFICATE PROGRAM.—Subclause (V) of section 25(c)(2)(A)(iii) (defining qualified mortgage credit certificate program) is amended by striking out "paragraph (1) of subsection (j)" and inserting in lieu thereof "subsection (j), other than paragraph (2) thereof".

(b) GOOD FAITH EFFORT RULES MADE APPLICABLE.—Subparagraph (A) of section 25(c)(2) (defining qualified mortgage credit certificate program) is amended by adding at the end thereof the following new sentence:

> "Under regulations, rules similar to the rules of subparagraphs (B) and (C) of section 103A(c)(2) shall apply to the requirements of this subparagraph."

(c) CARRYFORWARD OF EXCESS CREDIT.—Subparagraph (B) of section 25(e)(1) (relating to carryforward of unused credit) is amended to read as follows:

> "(B) LIMITATION.—The amount of the unused credit which may be taken into account under subparagraph (A) for any taxable year shall

not exceed the amount (if any) by which the applicable tax limit for such taxable year exceeds the sum of—

"(i) the credit allowable under subsection (a) for such taxable year determined without regard to this paragraph, and

"(ii) the amounts which, by reason of this paragraph, are carried to such taxable year and are attributable to taxable years before the unused credit year."

(d) CLERICAL AMENDMENTS.—

(1) Subparagraph (B) of section 25(a)(1) is amended by striking out "paid or incurred" and inserting in lieu thereof "paid or accrued".

(2) Subchapter B of chapter 68 is amended by redesignating the section 6708 which relates to penalties with respect to mortgage credit certificates as section 6709.

(3) The table of sections for subchapter B of chapter 68 is amended by striking out the item relating to the section 6708 which relates to penalties with respect to mortgage credit certificates and inserting in lieu thereof the following:

"Sec. 6709. Penalties with respect to mortgage credit certificates."

SEC. 163. AMENDMENT RELATED TO SECTION 613 OF THE ACT.

Section 613 of the Tax Reform Act of 1984 (relating to authority to borrow from Federal Financing Bank) is amended to read as follows:

"SEC. 613. ADVANCE REFUNDING OF CERTAIN VETERANS' MORTGAGE BONDS PERMITTED.

"(a) IN GENERAL.—Notwithstanding section 103A(n) of the Internal Revenue Code of 1954, an issuer of applicable mortgage bonds may issue advance refunding bonds with respect to such applicable mortgage bonds.

"(b) LIMITATION ON AMOUNT OF ADVANCED REFUNDING.—

"(1) IN GENERAL.—The amount of advanced refunding bonds which may be issued under subsection (a) shall not exceed the lesser of—

"(A) $300,000,000, or

"(B) the excess of—

"(i) the projected aggregate payments of principal on the applicable mortgage bonds during the 15-fiscal year period beginning with fiscal year 1984, over

"(ii) the projected aggregate payments during such period of principal on mortgages financed by the applicable mortgage bonds.

"(2) ASSUMPTIONS USED IN MAKING PROJECTION.—The computation under paragraph (1)(B) shall

be made by using the following percentages of the prepayment experience of the Federal Housing Administration in the State or region in which the issuer of the advance refunding bonds is located:

"Fiscal Year:	Percentage:
1984	15
1985	20
1986	25
1987 and thereafter	30.

"(c) DEFINITIONS.—For purposes of this section.—

"(1) APPLICABLE MORTGAGE BONDS.—The term 'applicable mortgage bonds' means any qualified veterans' mortgage bonds issued as part of an issue—

"(A) which was outstanding on December 5, 1980,

"(B) with respect to which the excess determined under subsection (b)(1)(B) exceeds 12 percent of the aggregate principal amount of such bonds outstanding on July 1, 1983,

"(C) with respect to which the amount of the average annual prepayments during fiscal years 1981, 1982, and 1983 was less than 2 percent of the average of the loan balances as of the beginning of each of such fiscal years, and

"(D) which, for fiscal year 1983, had a prepayment experience rate that did not exceed 20 percent of the prepayment experience rate of the

Federal Housing Administration in the State or region in which the issuer is located.

"(2) QUALIFIED VETERANS' MORTGAGE BONDS.—The term 'qualified veterans' mortgage bonds' has the meaning given to such term by section 103A(c)(3) of the Internal Revenue Code of 1954.

"(3) FISCAL YEAR.—The term 'fiscal year' means the fiscal year of the State."

SEC. 164. AMENDMENTS RELATED TO SECTION 621 OF THE ACT.

(a) SPECIAL RULE FOR FACILITIES LOCATED OUTSIDE THE STATE.—

(1) IN GENERAL.—Subsection (n) of section 103 (relating to limitation on aggregate amount of private activity bonds issued during any calendar year) is amended by adding at the end thereof the following new paragraph:

"(13) FACILITY MUST BE LOCATED WITHIN STATE.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), no portion of the State ceiling applicable to any State for any calendar year may be used with respect to financing for a facility located outside such State.

"(B) EXCEPTION FOR CERTAIN FACILITIES WHERE STATE WILL GET PROPORTIONATE SHARE OF BENEFITS.—Subparagraph (A) shall not apply to any issue described in subparagraph (E), (G), or (H) of subsection (b)(4) if the issuer establishes that the State's share of the use of the facility (or its output) will equal or exceed the State's share of the private activity bonds issued to finance the facility."

(2) EFFECTIVE DATE.—The amendment made by paragraph (1) shall apply to obligations issued after the date of the enactment of this Act in taxable years ending after such date.

(b) CLARIFICATION OF AUTHORITY FOR DIFFERENT ALLOCATION.—Subparagraphs (A) and (B)(i) of section 103(n)(6) (relating to State may provide for different allocation) are each amended by striking out "governmental units" and inserting in lieu thereof "governmental units or other authorities."

(c) CLARIFICATION OF EXCEPTION FOR CERTAIN FACILITIES.—Clause (i) of section 103(n)(7)(C) (relating to exception for certain facilities described in section 103(b)(4) (C) or (D)) is amended by striking out "the property described in such subparagraph" and inserting in lieu thereof "all of the property to be financed by the obligation".

(d) INFORMATION REPORTING ON ALLOCATION OF PRIVATE ACTIVITY BOND LIMIT.—Paragraph (2) of section 103(1) (relating to information reporting requirements for certain bonds) is amended by striking out "and" at the end of subparagraph (D), by striking out the period at the end of subparagraph (E) and inserting in lieu thereof ", and", and by adding at the end thereof the following new subparagraph:

"(F) if such obligation is a private activity bond (as defined in subsection (n)(7)), such information as the Secretary may require for purposes of determining whether the requirements of subsection (n) are met with respect to such obligation."

SEC. 165. AMENDMENT RELATED TO SECTION 622 OF THE ACT.

Subparagraph (A) of section 103(h)(5) (relating to certain obligations subsidized under energy program) is amended by striking out "the United States,".

SEC. 166. AMENDMENTS RELATED TO SECTION 626 OF THE ACT.

(a) Subsection (o) of section 103 (relating to denial of tax exemption for consumer loan bonds) is amended—

(1) by striking out "consumer loan bond" each place it appears and inserting in lieu thereof "private loan bond",

(2) by striking out "CONSUMER LOAN BONDS" in the subsection heading and inserting in lieu thereof "PRIVATE LOAN BONDS", and

(3) by striking out "CONSUMER LOAN BONDS" in the heading for paragraph (2) and inserting in lieu thereof "PRIVATE LOAN BONDS".

(b) Section 103 is amended by redesignating the subsection (o) relating to cross references as subsection (p).

SEC. 167. AMENDMENT RELATED TO SECTION 627 OF THE ACT.

Subparagraph (A) of section 103(b)(16) (relating to limitation on use for land acquisition) is amended by striking out "clause (i)" in the last sentence and inserting in lieu thereof "clause (ii)".

SEC. 168. AMENDMENTS RELATED TO SECTION 628 OF THE ACT.

(a) CERTAIN RESTRICTIONS APPLY TO EXEMPTIONS NOT CONTAINED IN INTERNAL REVENUE CODE OF 1954.—

(1) IN GENERAL.—Paragraph (1) of section 103(m) (relating to obligations exempt other than under this title) is amended by striking out "(k), (l), and (n)" and inserting in lieu thereof "(j), (k), (l), (n), and (o)".

(2) EFFECTIVE DATE.—The amendment made by paragraph (1) shall apply to obligations issued after

March 28, 1985, in taxable years ending after such date.

(b) CONFORMING AMENDMENTS TO REPEAL OF ADVANCED REFUNDING OF QUALIFIED PUBLIC FACILITIES.—Paragraphs (13), (14)(A), and (17)(A) of section 103(b) are each amended by striking out "(6), and (7)" and inserting in lieu thereof "and (6)".

SEC. 169. AMENDMENTS RELATED TO SECTION 631 OF THE ACT.

(a) CLARIFICATION OF GENERAL EFFECTIVE DATE.—

(1) Paragraph (1) of section 631(c) of the Tax Reform Act of 1984 (relating to effective date for other provisions relating to tax-exempt bonds) is amended by striking out "made by this subtitle" and inserting in lieu thereof "made by sections 622, 623, 627, and 628 (c), (d), and (e) (and the provisions of sections 625(c), 628(f), and 629(b))".

(2)(A) Subparagraph (A) of section 631(c)(3) of the Tax Reform Act of 1984 is amended by striking out "amendments made by this subtitle (other than section 621)" and inserting in lieu thereof "amendments (and provisions) referred to in paragraph (1)".

(B) Effective with respect to obligations issued after March 28, 1985, subparagraph (A) of section

631(c)(3) of the Tax Reform Act of 1984 is amended by striking out clauses (i) and (ii) and inserting in lieu thereof the following:

"(i) the original use of which commences with the taxpayer and the construction, reconstruction, or rehabilitation of which began before October 19, 1983, and was completed on or after such date, or

"(ii) with respect to which a binding contract to incur significant expenditures for construction, reconstruction, or rehabilitation was entered into before October 19, 1983, and some of such expenditures are incurred on or after such date."

(3) Paragraph (3) of section 631(c) of the Tax Reform Act of 1984 is amended by adding at the end thereof the following new subparagraph:

"(C) EXCEPTION.—Subparagraph (A) shall not apply with respect to the amendment made by section 628(e) and the provisions of sections 628(f) and 629(b)."

(4) Subparagraph (B) of section 631(c)(3) of the Tax Reform Act of 1984 is amended by striking out "subsection (b)(2)(A)" and inserting in lieu thereof "subsection (b)(2)".

(b) SPECIAL RULE FOR HEALTH CLUB FACILITIES.—Subsection (c) of section 631 of the Tax Reform Act of 1984 is amended by adding at the end thereof the following new paragraph:

"(5) SPECIAL RULE FOR HEALTH CLUB FACILITIES.—In the case of any health club facility, with respect to the amendment made by section 627(c)—

"(A) paragraph (1) shall be applied by substituting 'April 12, 1984' for 'December 31, 1983', and

"(B) paragraph (3) shall be applied by substituting 'April 13, 1984' for 'October 19, 1983' each place it appears."

(c) TREATMENT OF CERTAIN SOLID WASTE DISPOSAL FACILITIES.—

(1) IN GENERAL.—Subsection (d) of section 631 of the Tax Reform Act of 1984 (relating to provisions of subtitle not to apply to certain property) is amended by adding at the end thereof the following:

"(5) Any solid waste disposal facility described in section 103(b)(4)(E) of the Internal Revenue Code of 1954 if—

"(A) a city government, by resolutions adopted on April 10, 1980, and December 27, 1982, took formal action to authorize the submis-

sion of a proposal for a feasibility study for such facility and to authorize the presentation to the Department of the Army (U.S. Army Missile Command) of a proposed agreement to jointly pursue construction and operation of such facility,

"(B) such city government (or a public authority on its behalf) issues obligations for such facility before January 1, 1987, and

"(C) expenditures have been made for the development of such facility before October 19, 1983. Notwithstanding the foregoing provisions of this subsection, the amendments made by section 623 (relating to arbitrage) shall apply to obligations issued to finance property described in paragraph (5)."

(2) CONFORMING AMENDMENT.—Paragraph (1) of section 632(a) of the Tax Reform Act of 1984 is hereby repealed.

SEC. 170. AMENDMENT RELATED TO SECTION 632 OF THE ACT.

Subsection (a) of section 632 of the Tax Reform Act of 1984 is amended by striking out "section 623" in the matter preceding paragraph (1) thereof and inserting in lieu thereof "section 624".

PART G—MISCELLANEOUS PROVISIONS

SEC. 171. AMENDMENTS RELATED TO TITLE VII OF THE ACT.

(a) AMENDMENTS RELATED TO SECTION 713.—

(1)(A) Section 402(a)(5)(F)(ii) (relating to special rules for key employees) is amended to read as follows:

"(ii) 5-PERCENT OWNERS.—An eligible retirement plan described in subclause (III) or (IV) of subparagraph (E)(iv) shall not be treated as an eligible retirement plan for the transfer of a distribution if the employee is a 5-percent owner at the time such distribution is made. For purposes of the preceding sentence, the term '5-percent owner' means any individual who is a 5-percent owner (as defined in section 416(i)(1)(B)) at any time during the 5 plan years preceding the plan year in which the distribution is made."

(B) The amendments made by subparagraph (A) shall apply to distributions after the date of the enactment of this Act.

(2) Section 713(c) of the Tax Reform Act of 1984 is amended by adding at the end thereof the following new paragraph:

"(4) EFFECTIVE DATE FOR PARAGRAPH (3).—The amendment made by paragraph (3) shall apply to distributions after July 18, 1984."

(3) Section 62(7) (relating to pension, profit-sharing, and annuity plans of self-employed individuals) is amended by striking out "to the extent attributable to contributions made on behalf of such individual".

(4) Section 219(f)(1) (defining compensation) is amended by striking out "reduced by any amount allowable as a deduction to the individual in computing adjusted gross income under paragraph (7) of section 62".

(5) Section 713(d)(1) of the Tax Reform Act of 1984 is amended by striking out "Paragraph" and inserting in lieu thereof "Effective with respect to contributions made in taxable years beginning after December 31, 1983, paragraph".

(6)(A) Section 408(d)(5) (relating to certain distributions of excess contributions after due date) is amended by striking out "$15,000" and inserting in lieu thereof "the dollar limitation in effect under section 415(c)(1)(A) for such taxable year".

(B) Subparagraph (C) of section 219(b)(2) is amended by striking out "the $15,000 amount specified in subparagraph (A)(ii)" and inserting in lieu thereof "the dollar limitation in effect under section 415(c)(1)(A)".

(7) Paragraph (6) of section 713(d) of the Tax Reform Act of 1984 is amended by striking out "Subparagraph (D)" and inserting in lieu thereof "Subparagraph (C)".

(8) Subparagraph (A) of section 408(d)(3) is amended—

(A) by striking out "(other than a trust forming part of a plan under which the individual was an employee within the meaning of section 401(c)(1) at the time contributions were made on his behalf under the plan)" in clause (ii),

(B) by striking out "(other than a plan under which the individual was an employee within the meaning of section 401(c)(1) at the time contributions were made on his behalf under the plan)" in clause (ii), and

(C) by adding at the end thereof the following new sentence:

"Clause (ii) shall not apply during the 5-year period beginning on the date of the qualified total distribution referred to in such clause if the individual was treated as a 5-percent owner with respect to such distribution under section 402(a)(5)(F)(ii)."

(9) Clause (iii) of section 415(b)(2)(E) is amended by striking out "adjusting any benefit or limitation

under subparagraph (B), (C), or (D)" and inserting in lieu thereof "this subsection".

(10) Subparagraph (B) of section 3405(d)(1) is amended by striking out "or" at the end of clause (ii), and by striking out the material following clause (ii) and inserting in lieu thereof the following:

"(iii) any amount which is subject to withholding under subchapter A of chapter 3 (relating to withholding of tax on nonresident aliens and foreign corporations) by the person paying such amount or which would be so subject but for a tax treaty, or

"(iv) any distribution described in section 404(k)(2)."

(11) Subsection (a) section 6041 is amended by striking out "6047(e)" and inserting in lieu thereof "6047(d)".

(12) The amendments made by paragraphs (3), (4), and (6) shall take effect as if included in the amendments made by section 238 of the Tax Equity and Fiscal Responsibility Act of 1982.

(b) EFFECTIVE DATE FOR SECTION 714(n)(2) OF THE ACT.—Notwithstanding section 715 of the Tax Reform Act of 1984, the amendments made by section 714(n)(2) of such Act shall apply only to applications filed after July 18, 1984.

(c) AMENDMENT RELATED TO SECTION 734 OF THE ACT.—Subsection (a) of section 201 of the Land and Water Conservation Fund Act of 1965 (16 U.S.C. 460l–11) is amended by striking out "section 209(f)(5) of the Highway Revenue Act of 1956" and inserting in lieu thereof "section 9503(c)(4)(B) of the Internal Revenue Code of 1954".

(d) AMENDMENT RELATED TO SECTION 735 OF THE ACT.—The table of sections for part I of subchapter A of chapter 32 is amended by striking out "guzzlers" and inserting in lieu thereof "guzzler".

SEC. 172. AMENDMENTS RELATED TO TITLE VIII OF THE ACT.

(a) TREATMENT OF SECTION 923(a)(2) NON-EXEMPT INCOME.—

(1) Paragraph (6) of section 927(d) (defining section 923(a)(2) non-exempt income) is amended by adding at the end thereof the following new sentence: "Such term shall not include any income which is effectively connected with the conduct of a trade or business within the United States (determined without regard to this subpart)."

(2) Paragraph (6) of section 1248(d) (relating to foreign trade income) is amended to read as follows:

"(6) FOREIGN TRADE INCOME.—Earnings and profits of the foreign corporation attributable to foreign

trade income of a FSC other than foreign trade income which—

"(A) is section 923(a)(2) non-exempt income (within the meaning of section 927(d)(6)), or

"(B) would not (but for section 923(a)(4)) be treated as exempt foreign trade income.

For purposes of the preceding sentence, the terms 'foreign trade income' and 'exempt foreign trade income' have the respective meanings given such terms by section 923."

(b) CLARIFICATION OF PREFERENCE CUTBACKS.—

(1) Paragraph (4) of section 291(a) (relating to 20-percent reduction in certain preference items, etc.) is amended to read as follows:

"(4) CERTAIN FSC INCOME.—In the case of taxable years beginning after December 31, 1984, section 923(a) shall be applied with respect to any FSC by substituting—

"(A) '30 percent' for '32 percent' in paragraph (2), and

"(B) '15⅔' for '16⅔' in paragraph (3).

If all of the stock in the FSC is not held by 1 or more C corporations throughout the taxable year, under regulations, proper adjustments shall be made in the appli-

cation of the preceding sentence to take into account stock held by persons other than C corporations."

(2) Subparagraph (F) of section 995(b)(1) (relating to deemed distributions from a DISC) is amended—

(A) by inserting "in the case of a shareholder which is a C corporation," before "one-seventeenth" in clause (i), and

(B) by striking out "the amount determined under clause (i)" in clause (ii) and inserting in lieu thereof "16/17 of the excess referred to in clause (i),".

(3) Subsection (a) of section 923 (defining exempt foreign trade income) is amended by adding at the end thereof the following new paragraph:

"(6) CROSS REFERENCE.—

"For reduction in amount of exempt foreign trade income, see section 291(a)(4)."

(c) TREATMENT OF FOREIGN TRADE INCOME UNDER SUBPART F.—

(1) Subsection (b) of section 952 (relating to exclusion of United States income) is amended by adding at the end thereof the following new sentence: "For purposes of the preceding sentence, income described in paragraph (2) or (3) of section 921(d) shall be treated as derived from sources within the United States."

(2) Paragraph (1) of section 951(e) is amended by striking out the last sentence.

(d) DIVIDENDS RECEIVED DEDUCTION FOR CERTAIN DISTRIBUTIONS FROM A FSC.—

(1) DEDUCTION FOR CERTAIN DIVIDENDS.—

(A) Paragraph (1) of section 245(c) (relating to certain dividends received from FSC) is amended to read as follows:

"(1) IN GENERAL.—In the case of a domestic corporation, there shall be allowed as a deduction an amount equal to—

"(A) 100 percent of any dividend received by such corporation from another corporation which is distributed out of earnings and profits attributable to foreign trade income for a period during which such other corporation was a FSC, and

"(B) 85 percent of any dividend received by such corporation from another corporation which is distributed out of earnings and profits attributable to qualified interest and carrying charges received or accrued by such other corporation while such other corporation was a FSC.

The deduction allowable under the preceding sentence with respect to any dividend shall be in lieu of any de-

duction allowable under subsection (a) or (b) with respect to such dividend."

(B) Paragraph (3) of section 245(c) (relating to definitions) is amended by adding at the end thereof the following new sentence: "For purposes of this subsection, the term 'qualified interest and carrying charges' means any interest or carrying charges (as defined in section 927(d)(1)) derived from a transaction which results in foreign trade income."

(2) SEPARATE APPLICATION OF SECTION 904.—Subparagraph (D) of section 904(d)(1) is amended to read as follows:

"(D) distributions from a FSC (or a former FSC) out of earnings and profits attributable to foreign trade income (within the meaning of section 923(b)) or qualified interest and carrying charges (as defined in section 245(c)), and".

(3) COORDINATION OF SECTIONS 906 AND 902.—Subsection (b) of section 906 (relating to nonresident alien individuals and foreign corporations) is amended by adding at the end thereof the following new paragraph:

"(6) For purposes of section 902, any income, war profits, and excess profits taxes paid or accrued (or

deemed paid or accrued) to any foreign country or possession of the United States with respect to income effectively connected with the conduct of a trade or business within the United States shall not be taken into account, and any accumulated profits attributable to such income shall not be taken into account."

(e) EXCHANGE OF INFORMATION REQUIREMENTS.—

(1) Paragraph (3) of section 927(e) (relating to exchange of information requirements) is amended—

(A) by striking out "unless, at the same time such corporation was created or organized, there was" an inserting in lieu thereof "unless there is",

(B) by striking out "section 274(h)(6)(C)" in subparagraph (A) and inserting in lieu thereof "section 274(h)(6)(C) (determined by treating any reference to a beneficiary country as being a reference to any foreign country)", and

"(C) by amending subparagraph (B) to read as follows:

"(B) an income tax treaty which contains an exchange of information program—

"(i) which the Secretary certifies (and has not revoked such certification) is satisfactory in practice for purposes of this title, and

"(ii) to which the FSC is subject."

(2) Paragraph (2) of section 924(c) (relating to requirement that FSC be managed outside the United States) is amended to read as follows:

"(2) the principal bank account of the corporation is maintained in a foreign country which meets the requirements of section 927(e)(3) or in a possession of the United States, and".

(f) COORDINATION WITH POSSESSIONS TAXATION.—

(1) Paragraph (5) of section 927(e) (relating to exemption from certain other taxes) is amended to read as follows:

"(5) COORDINATION WITH POSSESSIONS TAXATION.—

"(A) EXEMPTION.—No tax shall be imposed by any possession of the United States on any foreign trade income derived before January 1, 1987. The preceding sentence shall not apply to any income attributable to the sale of property or the performance of services for ultimate use, consumption, or disposition within the possession.

"(B) CLARIFICATION THAT POSSESSION MAY EXEMPT CERTAIN INCOME FROM TAX.—Nothing in any provision of law shall be construed as prohibiting any possession of the United States

from exempting from tax any foreign trade income of a FSC or any other income of a FSC described in paragraph (2) or (3) of section 921(d).

"(C) NO COVER OVER OF TAXES IMPOSED ON FSC.—Nothing in any provision of law shall be construed as requiring any tax imposed by this title on a FSC to be covered over (or otherwise transferred) to any possession of the United States."

(2) CLERICAL AMENDMENT.—Section 934 is amended by striking out the subsection (f) added by section 801(d)(7) of the Tax Reform Act of 1984.

(g) CLARIFICATION OF INTEREST ON DISC-RELATED DEFERRED TAX LIABILITY.—Subsection (f) of section 995 (relating to interest on DISC-related deferred tax liability) is amended by adding at the end thereof the following new paragraph:

"(7) DISC INCLUDES FORMER DISC.—For purposes of this subsection, the term 'DISC' includes a former DISC."

(h) CLARIFICATION OF EXEMPTION OF ACCUMULATED DISC INCOME.—Subparagraph (A) of section 805(b)(2) of the Tax Reform Act of 1984 (relating to exemption of accumulated DISC income from tax) is amended by adding at the end thereof the following new sentence: "For purposes of

the preceding sentence, the term 'actual distribution' includes a distribution in liquidation, and the earnings and profits of any corporation receiving a distribution not included in gross income by reason of the preceding sentence shall be increased by the amount of such distribution."

(i) CLARIFICATION OF EFFECTIVE DATE FOR REQUIREMENT THAT TAXABLE YEAR OF DISC AND FSC CONFORM TO TAXABLE YEAR OF MAJORITY SHAREHOLDER.—Paragraph (4) of section 805(a) of the Tax Reform Act of 1984 is amended to read as follows:

"(4) SECTION 803.—The amendments made by section 803 shall apply to taxable years beginning after December 31, 1984.

(j) CLERICAL AMENDMENTS.—

(1) Subsection (f) of section 995 is amended by redesignating the paragraphs following the paragraph (3) relating to deferred DISC income as paragraphs (4), (5), and (6).

(2) Subsection (h) of section 901 is amended by striking out "section 927(d)(6)" and inserting in lieu thereof "section 927(d)(6))".

(3) Paragraph (3) of section 802(c) of the Tax Reform Act of 1984 is hereby repealed.

(4) Subparagraph (A) of section 805(a)(2) of the Tax Reform Act of 1984 is amended by striking out

"the taxpayer" and inserting in lieu thereof "the DISC or a related party".

(5) Paragraph (2) of section 927(e) is amended by striking out "clauses (i) and (ii)" and inserting in lieu thereof "clauses (ii) and (iii)".

SEC. 173. AMENDMENTS RELATED TO TITLE IX OF THE ACT.

(a) AMENDMENT RELATED TO SECTION 911 OF THE ACT.—Paragraph (3) of section 34(a) (relating to credit for certain uses of gasoline and special fuels) is amended to read as follows:

"(3) under section 6427—

"(A) with respect to fuels used for nontaxable purposes or resold, or

"(B) with respect to any qualified diesel-powered highway vehicle purchased (or deemed purchased under section 6427(g)(6)),

during the taxable year (determined without regard to section 6427(j))."

(b) AMENDMENTS RELATED TO SECTION 915 OF THE ACT.—

(1) Paragraph (2) of section 6427(b) (relating to intercity, local, or school buses) is amended by redesignating subparagraphs (B) and (C) as subparagraphs (C) and (D), respectively, and by inserting after subparagraph (A) the following new subparagraph:

"(B) EXCEPTION FOR SCHOOL BUS TRANSPORTATION.—Subparagraph (A) shall not apply to fuel used in an automobile bus while engaged in the transportation described in paragraph (1)(B)."

(2) Subparagraph (A) of section 6427(b)(2) is amended by striking out "subparagraph (B)" and inserting in lieu thereof "subparagraphs (B) and (C)".

(3) The heading for subparagraph (C) of section 6427(b)(2), as redesignated by paragraph (1), is amended by striking out "EXCEPTION" and inserting in lieu thereof "EXCEPTION FOR CERTAIN INTRACITY TRANSPORTATION".

SEC. 174. AMENDMENTS RELATED TO TITLE X OF THE ACT.

(a) AMENDMENT RELATED TO SECTION 1001 OF THE ACT.—Subsection (b) of section 1001 of the Tax Reform Act of 1984 is amended by adding at the end thereof the following new paragraph:

"(24) Clause (i) of section 1278(a)(1)(B) (relating to short-term obligations)."

(b) AMENDMENT RELATED TO SECTION 1015 OF THE ACT.—Subparagraph (I) of section 4162(a)(6) (defining sport fishing equipment) is amended to read as follows:

"(I) fishing hook disgorgers, and".

(c) AMENDMENTS RELATED TO SECTION 1018 OF THE ACT.—

(1) Paragraph (1) of section 4041(l) (relating to exemption for certain helicopter uses) is amended to read as follows:

"(1) transporting individuals, equipment, or supplies in the exploration for, or the development or removal of, hard minerals, oil, or gas, or".

(2) Paragraph (1) of section 4261(e) (relating to exemption for certain helicopter uses) is amended to read as follows:

"(1) transporting individuals, equipment, or supplies in the exploration for, or the development or removal of, hard minerals, oil, or gas, or".

(d) AMENDMENTS RELATED TO SECTION 1034 OF THE ACT.—

(1) The last sentence of section 514(c)(9)(B) (relating to exceptions) is amended by striking out "would be unrelated business taxable income (determined without regard to this paragraph)" and inserting in lieu in lieu thereof "is unrelated business taxable income".

(2) Clause (i) of section 514(c)(9)(C) is amended by striking out "section 509(a)" and inserting in lieu thereof "section 509(a)(3)".

(e) AMENDMENTS RELATED TO SECTION 1041 OF THE ACT.—

(1) The subsection (j) of section 51 (relating to targeted jobs credit) added by section 1041 of the Tax Reform Act of 1984 is hereby redesignated as subsection (k).

(2) Subparagraph (B) of section 1041(c)(5) of the Tax Reform Act of 1984 is amended by striking out "section 51(j)" and inserting in lieu thereof "section 51(k)".

(f) AMENDMENT RELATED TO SECTION 1053 OF THE ACT.—Paragraph (2) of section 1034(h) (relating to members of armed forces) is amended by striking out "before the last day described" and inserting in lieu thereof "before the day which is 1 year after the last day described".

(g) AMENDMENT RELATED TO SECTION 1063 OF THE ACT.—Subsection (c) of section 1063 of the Tax Reform Act of 1984 (relating to permanent disallowance of deduction for expenses of demolition of certain structures) is amended to read as follows:

"(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years ending after December 31, 1983, but shall not apply to any demolition (other than of a certified historic structure) commencing before July 19, 1984."

(h) AMENDMENT RELATED TO SECTION 1065 OF THE ACT.—Subsection (b) of section 1065 of the Tax Reform Act of 1984 (relating to rules treating Indian tribal governments as States) is amended by striking out "section 7871" and inserting in lieu thereof "section 7871(a)".

SEC. 175. MISCELLANEOUS PROVISIONS.

(a) WAIVER OF ESTIMATED TAX PENALTIES.—No additional tax shall be made under section 6654 or 6655 of the Internal Revenue Code of 1954 (relating to failure to pay estimated income tax) for any period before April 16, 1985 (March 16, 1985 in the case of a taxpayer subject to section 6655 of such Code), with respect to any underpayment, to the extent that such underpayment was created or increased by any provision of the Tax Reform Act of 1984.

(b) AMENDMENTS RELATED TO ORPHAN DRUG CREDIT.—

(1) Clause (ii) of section 28(b)(2)(A) (defining clinical testing) is amended—

(A) by striking out "the date of such drug" in subclause (I) and inserting in lieu thereof "the date such drug", and

(B) by striking out "of such Act" in subclause (II) and inserting in lieu thereof "of such Act or, if the drug is a biological product, before the date on which a license for such drug is issued

under section 351 of the Public Health Services Act".

(2) Paragraph (1) of section 28(d) (defining rare disease or condition) is amended to read as follows:

"(1) RARE DISEASE OR CONDITION.—For purposes of this section, the term 'rare disease or condition' means any disease or condition which—

"(A) affects less than 200,000 persons in the United States, or

"(B) affects more than 200,000 persons in the United States but for which there is no reasonable expectation that the cost of developing and making available in the United States a drug for such disease or condition will be recovered from sales in the United States of such drug.

Determinations under the preceding sentence with respect to any drug shall be made on the basis of the facts and circumstances as of the date such drug is designated under section 526 of the Federal Food, Drug, and Cosmetic Act."

(3) The amendments made by this subsection shall apply to amounts paid or incurred after December 31, 1982, in taxable years ending after such date.

(c) TREATMENT OF SALES WITHIN AFFILIATED GROUP FOR PURPOSES OF SECTION 29.—

(1) Paragraph (8) of section 29(d) (relating to related persons) is amended by adding at the end thereof the following new sentence: "In the case of a corporation which is a member of an affiliated group of corporations filing a consolidated return, such corporation shall be treated as selling qualified fuels to an unrelated person if such fuels are sold to such a person by another member of such group."

(2) The amendment made by paragraph (1) shall take effect as if included in the amendments made by section 231 of Public Law 96–223.

(d) RETURNS AND RECORDS WITH RESPECT TO CERTAIN FRINGE BENEFITS.—

(1) Subsection (d) of section 6039D (added by section 1 of Public Law 98–611) is amended to read as follows:

"(d) DEFINITIONS.—For purposes of this section—

"(1) SPECIFIED FRINGE BENEFIT PLAN.—The term 'specified fringe benefit plan' means—

"(A) any qualified group legal services plan (as defined in section 120),

"(B) any cafeteria plan (as defined in section 125), and

"(C) any educational assistance plan (as defined in section 127).

"(2) APPLICABLE EXCLUSION.—The term 'applicable exclusion' means—

"(A) section 120 in the case of a qualified group legal services plan,

"(B) section 125 in the case of a cafeteria plan, and

"(C) section 127 in the case of an educational assistance plan."

(2) The section 6039D added by section 1 of Public Law 98–612 is hereby repealed.

(e) REPEAL OF JOINT COMMITTEE REPORT REQUIREMENT.—Section 6405 (relating to reports of refunds and credits) is amended by striking out subsection (b) and redesignating subsections (c), (d), and (e) as subsections (b), (c), and (d), respectively.

PART H—EFFECTIVE DATE

SEC. 181. EFFECTIVE DATE.

Except as otherwise provided in this title, any amendment made by this title shall take effect as if included in the provision of the Tax Reform Act of 1984 to which such amendment relates.

TITLE II—TECHNICAL CORRECTIONS IN OTHER PROGRAMS AFFECTED BY DEFICIT REDUCTION ACT OF 1984

PART A—AMENDMENTS RELATED TO SOCIAL SECURITY ACT PROGRAMS

SEC. 201. AMENDMENTS RELATED TO COVERAGE OF CHURCH EMPLOYEES (SECTION 2603 OF THE DEFICIT REDUCTION ACT).

(a) CLARIFICATION OF EXCEPTION FOR MEMBERS OF CERTAIN RELIGIOUS FAITHS.—Subsection (g) of section 1402 of the Internal Revenue Code of 1954 (relating to members of certain religious faiths) is amended by adding at the end thereof the following new paragraph:

"(5) SUBSECTION NOT TO APPLY TO CERTAIN CHURCH EMPLOYEES.—This subsection shall not apply with respect to services which are described in subparagraph (B) of section 3121(b)(8) (and are not described in subparagraph (A) of such section)."

(b) TREATMENT OF INCOME OF CERTAIN CHURCH, ETC., EMPLOYEES.—

(1) AMENDMENTS OF INTERNAL REVENUE CODE OF 1954.—

(A) IN GENERAL.—Section 1402 of such Code (relating to definitions for purposes of the

tax on self-employment income) is amended by adding at the end thereof the following new subsection:

"(j) SPECIAL RULES FOR CERTAIN CHURCH EMPLOYEE INCOME.—

"(1) COMPUTATION OF NET EARNINGS.—In applying subsection (a)—

"(A) church employee income shall not be reduced by any deduction;

"(B) church employee income and deductions attributable to such income shall not be taken into account in determining the amount of other net earnings from self-employment.

"(2) COMPUTATION OF SELF-EMPLOYMENT INCOME.—

"(A) SEPARATE APPLICATION OF SUBSECTION (b)(2).—Paragraph (2) of subsection (b) shall be applied separately—

"(i) to church employee income, and

"(ii) to other net earnings from self-employment.

"(B) $100 FLOOR.—In applying paragraph (2) of subsection (b) to church employee income, '$100' shall be substituted for '$400'.

"(3) COORDINATION WITH SUBSECTION (a)(12).—Paragraph (1) shall not apply to any amount allowable as a deduction under subsection (a)(12), and paragraph (1) shall be applied before determining the amount so allowable.

"(4) CHURCH EMPLOYEE INCOME DEFINED.—For purposes of this section, the term 'church employee income' means gross income for services which are described in section 3121(b)(8)(B) (and are not described in section 3121(b)(8)(A))."

(B) TECHNICAL AND CONFORMING AMENDMENTS.—

(i) NET EARNINGS.—Paragraph (14) of section 1402(a) of such Code (defining net earnings from self-employment) is amended to read as follows:

"(14) in the case of church employee income, the special rules of subsection (j)(1) shall apply."

(ii) SELF-EMPLOYMENT INCOME.—Subsection (b) of section 1402 of such Code is amended by adding at the end thereof the following new sentence: "In the case of church employee income, the special rules of subsection (j)(2) shall apply for purposes of paragraph (2)."

(iii) CONFORMING AMENDMENT.—The second sentence of section 1402(b) of such Code is amended by striking out "clause (1)" and inserting in lieu thereof "paragraph (1)".

(2) AMENDMENTS OF SOCIAL SECURITY ACT.—

(A) IN GENERAL.—Section 211 of the Social Security Act is amended by adding at the end thereof the following new subsection:

"(i)(1) In applying subsection (a)—

"(A) church employee income shall not be reduced by any deduction;

"(B) church employee income and deductions attributable to such income shall not be taken into account in determining the amount of other net earnings from self-employment.

"(2)(A) Subsection (b)(2) shall be applied separately—

"(i) to church employee income, and

"(ii) to other net earnings from self-employment.

"(B) In applying subsection (b)(2) to church employee income, '$100' shall be substituted for '$400'.

"(3) Paragraph (1) shall not apply to any amount allowable as a deduction under subsection (a)(11), and paragraph (1) shall be applied before determining the amount so allowable.

"(4) For purposes of this section, the term 'church employee income' means gross income for services which are described in section 210(a)(8)(B) (and are not described in section 210(a)(8)(A))."

(B) TECHNICAL AND CONFORMING AMENDMENTS.—

(i) NET EARNINGS.—Section 211(a)(13) of such Act is amended to read as follows: "(14) In the case of church employee income, the special rules of subsection (i)(1) shall apply."

(ii) SELF-EMPLOYMENT INCOME.—Section 211(b) of such Act is amended by adding at the end thereof the following new sentence: "In the case of church employee income, the special rules of subsection (i)(2) shall apply for purposes of paragraph (2)."

(3) EFFECTIVE DATE.—The amendments made by this subsection shall apply to remuneration paid or derived in taxable years beginning after December 31, 1984.

(c) REVOCATION OF ELECTION UNDER SECTION 3121(w).—Paragraph (2) of section 3121(w) of the Internal Revenue Code of 1954 (relating to timing and duration of election) is amended by striking out the last 2 sentences and inserting in lieu thereof the following: "The election may be

revoked by the church or organization under regulations prescribed by the Secretary. The election shall be revoked by the Secretary if such church or organization fails to furnish the information required under section 6051 to the Secretary for a period of 2 years or more with respect to remuneration paid for such services by such church or organization, and, upon request by the Secretary, fails to furnish all such previously unfurnished information for the period covered by the election. Any revocation under the preceding sentence shall apply retroactively to the beginning of the 2-year period for which the information was not furnished."

SEC. 202. CORRECTIONS RELATING TO ENROLLMENT AND PREMIUM PENALTY UNDER THE MEDICARE WORKING AGED PROVISION.

(a) PREMIUM PENALTY.—The second sentence of section 1839(b) of the Social Security Act (42 U.S.C. 1395r(b)), as amended by section 2338(a) of the Deficit Reduction Act of 1984, is amended by striking out "months in which" and all that follows through "clause (iv) of such section" and inserting in lieu thereof "months during which the individual has attained the age of 65 and for which the individual can demonstrate that the individual was enrolled in a group health plan described in section 1862(b)(3)(A)(iv)".

(b) SPECIAL ENROLLMENT PERIODS.—Section 1837(i) of the Social Security Act (42 U.S.C. 1395p), as added by

section 2338(b) of the Deficit Reduction Act of 1984, is amended—

(1) in paragraph (1) by amending subparagraph (A) to read as follows:

"(A) has attained the age of 65,"; and

(2) in paragraph (2), by redesignating subparagraph (C) as subparagraph (D) and by amending subparagraphs (A) and (B) to read as follows:

"(A) has attained the age of 65;

"(B)(i) has enrolled (or has been deemed to have enrolled) in the medical insurance program established under this part during the individual's initial enrollment period, or (ii) is an individual described in paragraph (1)(B);

"(C) has enrolled in such program during any subsequent special enrollment period under this subsection during which the individual was not enrolled in a group health plan described in section 1862(b)(3)(A)(iv) by reason of the individual's (or individual's spouse's) current employment; and".

(c) EFFECTIVE DATES.—

(1) The amendment made by subsection (a) shall apply to months beginning with January 1983 for premiums for months beginning with the first month that

begins more than 30 days after the date of the enactment of this Act.

(2)(A) The amendments made by subsection (b) shall apply to enrollments in months beginning with the first effective month (as defined in subparagraph (B)), except that in the case of any individual who would have a special enrollment period under section 1837(i) of the Social Security Act that would have begun after November 1984 and before the first effective month, the period shall be deemed to begin with the first day of the first effective month.

(B) For purposes of subparagraph (A), the term "first effective month" means the first month that begins more than 90 days after the date of the enactment of this Act.

SEC. 203. TECHNICAL CORRECTIONS IN OTHER PROVISIONS RELATED TO SOCIAL SECURITY ACT PROGRAMS.

(a) AMENDMENTS RELATING TO OASDI PROGRAM.—

(1) Section 202(c)(5)(B) of the Social Security Act is amended by striking out "or (I)" and inserting in lieu thereof "or (J)".

(2) Section 202(q)(5)(A)(i) of such Act is amended by striking out "prescribed by him" and inserting in lieu thereof "prescribed by the Secretary".

(3) Section 202(q)(5)(C) of such Act is amended by striking out "she shall be deemed" and inserting in lieu thereof "he or she shall be deemed".

(4) Section 203(a)(6) of such Act is amended by striking out the comma after "shall be".

(5) Section 210(a)(5)(G) of such Act is amended by striking out "Any other service" and inserting in lieu thereof "any other service".

(6) Effective on the date of the enactment of the Deficit Reduction Act of 1984—

(A) section 2601(d)(1)(B)(ii) of that Act is amended by striking out "210(a)(5)(g)(iii)" and inserting in lieu thereof "210(a)(5)(G)(iii)"; and

(B) section 2663(c)(1) of that Act is amended by striking out subparagraph (B).

(7) Section 211(c)(2) of the Social Security Act is amended by indenting subparagraph (G) two additional ems (for a total indentation of four ems) so as to align its left margin with the margins of the other subparagraphs in such section.

(8) Section 215(i)(5)(B) of such Act is amended—

(A) by striking out "subdivision (I)" in clause (ii) and inserting in lieu thereof "clause (i)(I)";

(B) by striking out "subdivisions (I) and (II)" in the matter between clauses (iii) and (iv) and inserting in lieu thereof "clause (i)".

(9) The heading of section 218(m) of such Act is amended to read as follows:

"Wisconsin Retirement Fund".

(10) Section 221(e) of such Act is amended by striking out "under this section" in the first sentence.

(11) Section 223(g)(1) of such Act is amended by striking out the second comma after the term "benefits" where such term first appears in the matter following subparagraph (C).

(12)(A) Section 1402(c)(2) of the Internal Revenue Code of 1954 is amended by indenting subparagraph (G) two additional ems (for a total indentation of four ems) so as to align its left margin with the margins of the other subparagraphs in such section.

(B) Section 3121(a)(8) of such Code is amended by moving subparagraph (B) two ems to the left, so that its left margin is in flush alignment with the margin of subparagraph (A) of such section.

(b) AMENDMENTS RELATING TO AFDC AND CHILD SUPPORT PROGRAMS.—

(1)(A) Section 402(a) of the Social Security Act is amended by striking out "and" after the semicolon at

the end of paragraph (37), and by making any additional changes which may be necessary to assure that paragraphs (34) through (37) each end with a semicolon, paragraph (38) ends with "; and", and paragraph (39) ends with a period.

(B) Effective on the date of the enactment of the Deficit Reduction Act of 1984, section 2639(a) of that Act is amended by striking out the period immediately following "utility providing home energy" (in the quoted matter) and inserting in lieu thereof a semicolon.

(2) The placement of the last sentence of section 402(a) of the Social Security Act is modified to the extent necessary to assure that it begins flush to the full left margin without any indentation, immediately after and below the last of the numbered paragraphs.

(3) Section 457(c) of such Act is amended by striking out "subsection (b)(3) (A) and (B)" in the matter following paragraph (2) and inserting in lieu thereof "subsection (b)(4) (A) and (B)".

(4) Section 458(d) of such Act is amended by striking out "on behalf of individuals residing in another State" and inserting in lieu thereof "at the request of another State".

(5) Section 464(b)(2)(A) of such Act is amended by striking out "threshhold" and inserting in lieu thereof "threshold".

(c) AMENDMENTS TO GENERAL PROVISIONS.—

(1) Section 1101(a) of such Act is amended by shifting paragraphs (3), (4), and (5) to the right to the extent necessary to assure that their left margins are aligned with the left margins of the other numbered paragraphs.

(2) Section 1136(b)(7) of such Act is amended by striking out "nongovermental" and inserting in lieu thereof "nongovernmental".

(d) AMENDMENTS RELATING TO SSI PROGRAM.—

(1) The heading of section 1631(g) of such Act is amended to read as follows:

"Reimbursement to States for Interim Assistance Payments".

(2) Section 1612(a)(1)(C) of such Act is amended by striking out "section 43" and inserting in lieu thereof "section 32".

(3) Section 1612(b) of such Act is amended by making any changes which may be necessary to assure that paragraph (11) ends with a semicolon, paragraph (12) ends with "; and", and paragraph (13) ends with a period.

(e) AMENDMENTS RELATING TO MEDICARE PROGRAM.—

(1)(A) Subclause (III) of section 1842(b)(7)(B)(ii) of the Social Security Act (42 U.S.C. 1395u(b)(7)(B)(ii)), as added by section 2307(a)(2)(G) of the Deficit Reduction Act of 1984, is amended by indenting it two additional ems to the right so as to align its left margin with the left margins of subclauses (I) and (II) of that section.

(B) Section 1861(n) of the Social Security Act (42 U.S.C. 1395x(n)), as inserted by section 2321(e)(3) of the Deficit Reduction Act of 1984, is amended by striking out "at his home" and inserting in lieu thereof "as his home".

(C) Section 1888(b) of the Social Security Act (42 U.S.C. 1395yy(b)), as added by section 2319(b) of the Deficit Reduction Act of 1984, is amended by striking out "nothwithstanding" and inserting in lieu thereof "notwithstanding".

(D) The amendments made by this paragraph shall be effective as if they had been originally included in the Deficit Reduction Act of 1984.

(2)(A) Clause (iii) of section 1842(b)(7)(B) of the Social Security Act (42 U.S.C. 1395u(b)(7)(B)), as added by section 3(b)(6) of Public Law 98–617, is

amended by moving its alignment two additional ems to the left so as to align its left margin with the left margins of clauses (i) and (ii) of that section.

(B) The amendment made by subparagraph (A) shall be effective as if it had been originally included in Public Law 98–617.

(3)(A) Section 1861(v)(1)(G)(i) of the Social Security Act (42 U.S.C. 1395x(b)(1)(G)(i)), as amended by section 602(d)(1) of the Social Security Amendments of 1983, is amended by inserting, in the matter after subclause (III), "on the basis of" after "(during such period)".

(B) The amendment made by subparagraph (A) shall be effective as if it had been originally included in the Social Security Amendments of 1983.

(f) AMENDMENTS RELATING TO SOCIAL SERVICES PROGRAM.—

(1)(A) Section 2003(d) of such Act is repealed.

(B) Section 2003(b) of such Act is amended by striking out "(subject to subsection (d))".

(2) Section 2007 of such Act is repealed.

(g) EFFECTIVE DATE.—Except as otherwise provided in this section, the amendments made by this section shall take effect on the date of the enactment of this Act.

PART B—AMENDMENTS RELATED TO UNEMPLOYMENT COMPENSATION PROGRAM

SEC. 211. TECHNICAL CORRECTIONS IN FEDERAL UNEMPLOYMENT TAX ACT

The Federal Unemployment Tax Act is amended as follows:

(1) Subparagraph (B) of section 3302(c)(2) (relating to a limit on the credit against the unemployment tax) is amended—

(A) by striking out "determination" the second place it appears in the material preceding clause (i) and inserting in lieu thereof "denominator", and

(B) in clause (i)—

(i) by striking out "percent" immediately preceding the comma at the end thereof, and

(ii) by inserting "percent" after "2.7".

(2) Subparagraph (A) of section 3302(f)(8) (relating to a partial limitation on the reduction of the credit against the unemployment tax) is amended by striking out "1987" and inserting in lieu thereof "1986".

(3) Clause (i) of section 3306(o)(1)(A) (relating to crew leaders who are registered or provide specialized agricultural labor) is amended by striking out "Farm Labor Contractor Registration Act of 1963" and in-

serting in lieu thereof "Migrant and Seasonal Agricultural Workers Protection Act".

PART C—AMENDMENTS RELATED TO TRADE AND TARIFF PROGRAMS

SEC. 221. AMENDMENTS TO THE TARIFF SCHEDULES.

The Tariff Schedules of the United States (19 U.S.C. 1202) are amended as follows:

(1) TELECOMMUNICATIONS PRODUCT CLASSIFICATION CORRECTIONS.—(A) Schedule 6 is amended as follows:

(i) Headnote 1 to subpart C of part 4 is amended by striking out "688.43" and inserting in lieu thereof "688.42".

(ii) Headnote 3 of part 5 of schedule 6 is amended by striking out "items 685.11 through 685.19, inclusive," and inserting in lieu thereof "items 684.92, 684.98, 685.00, and 685.08".

(iii) Item 685.34 is amended by inserting "35% ad val." in Column No. 2.

(iv) Item 685.55 is amended by striking out "685.11 to 685.50" and inserting in lieu thereof "684.92 to 685.49".

(B) Headnote 2(ii) to part 7 of schedule 8 is amended by striking out "688.43" and inserting in lieu thereof "688.42".

(2) CORRECTIONS TO THE APPENDIX.—Subpart B of part 1 to the Appendix is amended as follows:

(A) The article description for item 906.38 is amended to read as follows: "N-Acetylsulfanilyl chloride (provided for in item 405.31, part 1B, schedule 4)".

(B) Item 907.38 is amended by striking out "411.87" and inserting in lieu thereof "411.82".

(C) Item 912.13 is amended by striking out "670.20" and inserting in lieu thereof "670.21".

(3) MISCELLANEOUS CORRECTIONS.—The Schedules are further amended as follows:

(A) Headnote 1 of subpart D of part 4 of schedule 1 is amended by striking out "(casein plus albumin)" and inserting in lieu thereof "(casein plus lactalbumin)".

(B) Headnote 1 of subpart C of part 4 of schedule 3 is amended—

(i) by inserting "or" after the semicolon at the end of clause (v); and

(ii) by striking out "; or" at the end of clause (vi) and inserting in lieu thereof a period.

SEC. 222. TECHNICAL CORRECTIONS TO COUNTERVAILING AND ANTIDUMPING DUTY PROVISIONS.

(a) Title VII of the Tariff Act of 1930 is amended as follows:

(1)(A) Subsection (c) of section 701 (19 U.S.C. 1671(c)) is redesignated as subsection (d).

(B) Subsection (g) of such section 701 (as added by section 613(b) of the Trade and Tariff Act of 1984) is—

(i) amended by striking out "(g) Whenever" and inserting in lieu thereof "(c) UPSTREAM SUBSIDY.—Whenever"; and

(ii) inserted immediately after subsection (b) of that section.

(2) Sections 702(b)(1) and 732(b)(1) (19 U.S.C. 1671a(b)(1) and 1673a(b)(1)) are each amended by striking out "(C), (D), or (E)" and inserting in lieu thereof "(C), (D), (E), or (F)".

(3) Subsection (h) of section 703 (19 U.S.C. 1617b(h)) is redesignated as subsection (g), and—

(A) paragraph (2)(A) of that subsection (as so redesignated) is amended by striking out "days under section 705(a)(1) or 225 days under section 705(a)(2), as appropriate" and inserting in lieu thereof "or 225 days, as appropriate, under section 705(a)(1)"; and

(B) paragraph (2)(B)(ii) of that subsection (as so redesignated) is amended by striking out "days under section 705(a)(2)" and inserting in lieu thereof "or 225 days, as appropriate, under section 705(a)(1)".

(4) Section 704 is amended—

(A) by amending subsection (d)—

(i) by redesignating paragraph (2) as paragraph (3); and

(ii) by inserting after paragraph (1) the following new paragraph:

"(2) EXPORTS OF MERCHANDISE TO UNITED STATES NOT TO INCREASE DURING INTERIM PERIOD.—The administering authority may not accept any agreement under subsection (b) unless that agreement provides a means of ensuring that the quantity of the merchandise covered by that agreement exported to the United States during the period provided for elimination or offset of the subsidy or cessation of exports does not exceed the quantity of such merchandise exported to the United States during the most recent representative period determined by the administering authority."; and

(B) by amending subsection (i)(1)(D) by striking out "international" and inserting in lieu thereof "intentional".

(5) Paragraph (2) of section 706(a) is amended by aligning the margin of the matter appearing after subparagraph (B) with the margin of the matter appearing before subparagraph (A).

(6)(A) Section 708 is amended by striking out "SEC. 708." and inserting in lieu thereof the following flush section heading:

"SEC. 708. EFFECT OF DEROGATION OF EXPORT-IMPORT BANK FINANCING.".

(B) The table of contents for such title VII is amended by inserting in numerical sequence the following:

"Sec. 708. Effect of derogation of Export-Import Bank financing.".

(7) Section 736(c)(1) (19 U.S.C. 1673(c)(1)) is amended by inserting ", and was sold to any person that is not related to such manufacturer, producer, or exporter," immediately before "on or after the date of publication of—".

(8) The last sentence of section 751(b)(1) (19 U.S.C. 1675(b)(1)) is amended by inserting "or countervailing duty" after "antidumping" each place it appears.

(9) Section 771(7)(F)(i) (19 U.S.C. 1677(7)(F)(i)) is amended—

(A) by striking "any merchandise" in that part which precedes subclause (I) and inserting in lieu thereof "the merchandise"; and

(B) by striking out "find orders" in subclause (VIII) and inserting in lieu thereof "final orders".

(10) Section 771A(a) is amended by striking out "(ii), or (iii)" and inserting in lieu thereof "(ii), (iii), or (iv)".

(11) Subsection (g) of section 773 (19 U.S.C. 1677b(g)) is redesignated as subsection (f).

(12) Section 775 (19 U.S.C. 1677d) is amended by striking out "an proceeding" each place it appears therein and inserting in lieu thereof "a proceeding".

(13) Section 777 (19 U.S.C. 1677f) is amended—

(A) by striking out "confidential", "non-confidential", and "confidentiality" each place they appear therein and inserting in lieu thereof "proprietary", "non-proprietary", and "proprietary status", respectively; and

(B) by inserting "or the Commission" after "administering authority" in subsection (b)(1)(B)(i).

(b) Section 626(b) of the Trade and Tariff Act of 1984 (relating to the effective dates of the amendments made therein to title VII of the Tariff Act of 1930) is amended—

(1) by amending paragraph (1) by inserting ", and to reviews begun under section 751 of that Act," after "1930"; and

(2) by adding at the end thereof the following new paragraphs:

"(3) The administering authority may delay implementation of any of the amendments referred to in subsections (a) and (b)(1) with respect to any investigation in progress on the date of the enactment of this Act if the administering authority determines that immediate implementation would prevent compliance with a statutory deadline in title VII of the Tariff Act of 1930 that is applicable to that investigation.

"(4) The amendment made by section 621 shall apply with respect to merchandise that is unliquidated on or after November 4, 1984.".

SEC. 223. AMENDMENTS TO THE TRADE ACT OF 1974.

The Trade Act of 1974 is amended as follows:

(1) Section 128(b) (19 U.S.C. 2138) is amended by striking out "587.70" in paragraph (1) and inserting in lieu thereof "687.70".

(2) Subsection (n) of section 135 (as added by section 306(c)(2)(B)(v) of the Trade and Tariff Act of 1984) is redesignated as subsection (m).

(3) Section 141(d)(6) is amended by striking out "3679(b) of the Revised Statutes (31 U.S.C. 665(b))" and inserting in lieu thereof "1342 of title 31, United States Code".

(4) Subparagraphs (A), (B), and (C) of section 502(b)(4) are amended to read as follows:

"(A) has nationalized, expropriated, or otherwise seized ownership or control of property, including patents, trademarks, or copyrights, owned by a United States citizen or by a corporation, partnership, or association which is 50 percent or more beneficially owned by United States citizens,

"(B) has taken steps to repudiate or nullify an existing contract or agreement with a United States citizen or a corporation, partnership, or association which is 50 percent or more beneficially owned by United States citizens, the effect of which is to nationalize, expropriate, or otherwise seize ownership or control of property, including patents, trademarks, or copyrights, so owned, or

"(C) has imposed or enforced taxes or other exactions, restrictive maintenance or operational

conditions, or other measures with respect to property, including patents, trademarks, or copyrights, so owned, the effect of which is to nationalize, expropriate, or otherwise seize ownership or control of such property,".

(5) That part of section 504(c)(3)(D)(ii) (19 U.S.C. 2464(c)(3)(D)(ii)) that precedes subclause (I) is amended—

(A) by striking out "from any beneficiary developing country";

(B) by inserting "an aggregate value equal to" immediately before "15"; and

(C) by striking out "if for the preceding calendar year such beneficiary country—" and inserting in lieu thereof "for those beneficiary developing countries which for the preceding calendar year—".

SEC. 224. AMENDMENTS TO THE TARIFF ACT OF 1930.

The Tariff Act of 1930 is amended as follows:

(1) Section 304(c) (19 U.S.C. 1304(c)) is amended—

(A) by striking out "No" and inserting in lieu thereof the following: "(1) Except as provided in paragraph (2), no"; and

(B) by adding at the end thereof the following new paragraph:

"(2) If, because of the nature of an article, it is technically or commercially infeasible to mark it by one of the four methods specified in paragraph (1), the article may be marked by an equally permanent method of marking such as paint stenciling or, in the case of small diameter pipe and tube, by tagging the containers or bundles.".

(2) Section 313 (19 U.S.C. 1313), as amended by section 202(1) of the Trade and Tariff Act of 1984, is amended—

(A) by redesignating paragraphs (3) and (4) as paragraphs (2) and (3), respectively; and

(B) by amending paragraph (3) (as so redesignated) to read as follows:

"(3) The performing of incidental operations (including, but not limited to, testing, cleaning, repacking, and inspecting) on—

"(A) the imported merchandise itself in cases to which paragraph (1) applies; or

"(B) the merchandise of the same kind and quality in cases to which paragraph (2) applies:

that does not amount to manufacture or production for drawback purposes under the preceding provisions of this section

shall not be treated as a use of that merchandise for purposes of applying paragraph (1)(B) or (2)(C).".

(3) Section 339(c)(2)(A) (19 U.S.C. 1339) is amended by striking out "relief" and inserting in lieu thereof "injury".

(4) Section 514(a) of the Tariff Act of 1930 (19 U.S.C. 1514(a)) is amended by striking out "as defined in section 771(9) (C), (D), (E), and (F) of this Act".

(5) Section 516(a)(2) of the Tariff Act of 1930 (19 U.S.C. 1615(a)(2)) is amended by adding at the end thereof the following new sentence:

"Such term also means a person that is an association, a majority of whose members is composed of persons described in subparagraph (A), (B), or (C).".

(6) Section 516A(a)(3) of the Tariff Act of 1930 (19 U.S.C. 516a(a)(3)) is amended by striking out "(2)(A)(ii)" and inserting in lieu thereof "(2)(A)(i)(II)".

SEC. 225. AMENDMENTS TO THE TRADE AND TARIFF ACT OF 1984.

The Trade and Tariff Act of 1984 (Public Law 98–573) is amended as follows:

(1) Section 126 is amended—

(A) by striking out the following:

"(3) Paragraphs (1) and (2) of section 126 of the bill are amended to read as follows:"; and

(B) by striking out "8.3% ad val." in paragraph (1) and inserting in lieu thereof "7.5% ad val.".

(2) Section 174(b) is amended by adding at the end of the table appearing therein the following:

"January 1, 1987..... 4.9% ad val.".

(3) Paragraph (7) of subsection (b) of section 212 is redesignated as subsection (c) of that section.

(4) The table in section 234(a) is amended by striking out "711.49" and inserting in lieu thereof "712.49".

(5) Section 304(d)(2)(A) is amended—

(A) by striking out "paragraph (6)" in clause (i) and inserting in lieu thereof "paragraph (9)";

(B) by striking out "paragraph (7)" in clause (ii) and inserting in lieu thereof "paragraph (10)"; and

(C) by redesignating the paragraph proposed to be added by clause (iii) as paragraph (11) of section 141(d) of the Trade Act of 1974.

(6) Section 307(b)(3) is amended by striking out "or paragraph (3)".

(7) Section 504 is amended by striking out "Tariff Act of 1930" and inserting in lieu thereof "Trade Act of 1974".

(8) Paragraph (3) of section 619 is amended by striking out "subsection (b)" and inserting in lieu thereof "subsection (b)(1)".

SEC. 226. AMENDMENTS TO THE CARIBBEAN BASIN ECONOMIC RECOVERY ACT.

Section 213 of the Caribbean Basin Economic Recovery Act (19 U.S.C. 2703) is amended—

(1) by striking out "such" the first place it appears in subsection (a)(3) and inserting in lieu thereof "any beneficiary"; and

(2) by striking out "138.42" in subsection (f)(5)(B) and inserting in lieu thereof "138.46".

SEC. 227. CONFORMING AMENDMENTS REGARDING CUSTOMS BROKERS.

Title 28 of the United States Code is amended—

(1) by striking out "(3) or (c)" in section 1581(g)(1) and inserting in lieu thereof "(3)"; and

(2) by striking out "641(a)(1)(C)" in section 1582(1) and inserting in lieu thereof "641(b)(6)".

SEC. 228. SPECIAL EFFECTIVE DATE PROVISIONS FOR CERTAIN ARTICLES GIVEN DUTY-FREE TREATMENT UNDER THE TRADE AND TARIFF ACT OF 1984.

(a) Notwithstanding section 514 of the Tariff Act of 1930 or any other provision of law, upon proper request filed with the customs officer concerned on or before the 90th day

after the date of the enactment of this Act, the entry of any article described in subsection (b) shall be treated as provided for in that subsection.

(b) In the case of the application of any amendment made by sections 112, 115, 118, 167, and 179 of the Trade and Tariff Act of 1984 (Public Law 98–573) to any entry—

(1) which was made after the applicable date and before the 15th day after the date of the enactment of this Act; and

(2) with respect to which there would have been no duty or a lesser duty if the amendment made by any such section applied to such entry;

such entry shall be liquidated or reliquidated as though such entry had been made on the 15th day after the date of the enactment of this Act.

(c) For purposes of subsection (b), the term "applicable date" means—

(1) in the case of section 118, June 1, 1982;

(2) in the case of sections 112, 115, and 179, June 30, 1983; and

(3) in the case of section 167, October 30, 1983.

(d) For purposes of this section—

(1) The term "entered" means entered, or withdrawn from warehouse for consumption in the customs territory of the United States.

(2) The term "entry" includes any withdrawal from warehouse.

99TH CONGRESS
1ST SESSION

H. R. 2110

To make technical corrections related to the Retirement Equity Act of 1984.

IN THE HOUSE OF REPRESENTATIVES

APRIL 18, 1985

Mr. ROSTENKOWSKI (for himself, Mr. DUNCAN, Mr. CLAY, and Mrs. ROUKEMA) introduced the following bill; which was referred jointly to the Committees on Education and Labor and Ways and Means

---

A BILL

To make technical corrections related to the Retirement Equity Act of 1984.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. AMENDMENT OF 1954 CODE.

Except as otherwise expressly provided, whenever in this Act an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1954.

SEC. 2. TECHNICAL CORRECTIONS TO THE RETIREMENT EQUITY ACT OF 1984.

(a) AMENDMENTS RELATED TO SECTIONS 102 AND 202 OF THE ACT.—

(1) TREATMENT OF CLASS-YEAR PLANS.—

(A) AMENDMENT OF INTERNAL REVENUE CODE.—Paragraph (4) of section 411(d) (relating to class-year plans) is amended to read as follows:

"(4) CLASS-YEAR PLANS.—

"(A) IN GENERAL.—The requirements of subsection (a)(2) shall be treated as satisfied in the case of a class-year plan if such plan provides that 100 percent of each employee's right to or derived from the contributions of the employer on the employee's behalf with respect to any plan year are nonforfeitable not later than when such participant was performing services for the employer as of the close of each of 5 plan years (whether or not consecutive after the plan year for which the contributions were made.

"(B) 5-YEAR BREAK IN SERVICE.—For purposes of subparagraph (A) if—

"(i) any contributions are made on behalf of a participant with respect to any plan year, and

"(ii) before such participant meets the requirements of subparagraph (A), such participant was not performing services for the employer as of the close of each of any 5 consecutive plan years after such plan year, then the plan may provide that the participant forfeits any right to or derived from the contributions made with respect to such plan year.

"(C) CLASS-YEAR PLAN.—For purposes of this section, the term 'class-year plan' means a profit-sharing, stock bonus, or money purchase plan which provides for the separate nonforfeitability of employees' rights to or derived from the contributions for each plan year."

(B) AMENDMENT OF ERISA.—Paragraph (3) of section 203(c) of the Employee Retirement Income Security Act of 1974 is amended to read as follows:

"(3)(A) The requirements of subsection (a)(2) shall be treated as satisfied in the case of a class-year plan if such plan provides that 100 percent of each employee's right to or derived from the contributions of the employer on the employee's behalf with respect to any plan year are nonforfeitable not later than when such participant was performing services for the employer as

of the close of each of 5 plan years (whether or not consecutive) after the plan year for which the contributions were made.

"(B) For purposes of subparagraph (A) if—

"(i) any contributions are made on behalf of a participant with respect to any plan year, and

"(ii) before such participant meets the requirements of subparagraph (A), such participant was not performing services for the employer as of the close of each of any 5 consecutive plan years after such plan year.

then the plan may provide that the participant forfeits any rights to or derived from the contributions made with respect to such plan year.

"(C) For purposes of this part, the term 'class year plan' means a profit-sharing, stock bonus, or money purchase plan which provides for the separate nonforfeitablity of employees' rights to or derived from the contributions for each plan year."

(C) EFFECTIVE DATE.—The amendments made by this paragraph shall apply to contributions made for plan years beginning after the date of the enactment of this Act; except that, in the case of a plan described in section 302(b) of the Retirement Equity Act of 1984, such amendments

shall not apply to any plan year to which the amendments made by such Act do not apply by reason of such section 302(b).

(2) COORDINATION WITH LUMP SUM TREATMENT.—Subsection (e) of section 402 (relating to tax on lump sum distributions) is amended by adding at the end thereof the following new paragraph:

"(6) TREATMENT OF POTENTIAL FUTURE VESTING.—

"(A) IN GENERAL.—For purposes of determining whether any distribution which becomes payable to the recipient on account of the employee's separation from service is a lump sum distribution, the balance to the credit of the employee shall be determined without regard to any increase in vesting which may occur if the employee is re-employed by the employer.

"(B) RECAPTURE IN CERTAIN CASES.—If—

"(i) an amount is treated as a lump sum distribution by reason of subparagraph (A),

"(ii) the employee makes an election under paragraph (4)(B) with respect to such distribution;

"(iii) the employee is subsequently re-employed by the employer; and

"(iv) as a result of services performed after being so re-employed, there is an increase in the employee's vesting for benefits accrued before the separation referred to in subparagraph (A),

under regulations prescribed by the Secretary, the tax imposed by this chapter for the taxable year (in which the increase in vesting first occurs) shall be increased by the reduction in tax which resulted from the election referred to in clause (ii) (and such election shall not be taken into account for purposes of determining whether the employee may make another election under paragraph (4)(B)).

"(C) VESTING.—For purposes of this paragraph the term 'vesting' means the portion of the accrued benefits derived from employer contributions to which the participant has a nonforfeitable right."

(3) TREATMENT OF WITHDRAWAL OF MANDATORY CONTRIBUTIONS.—

(A) AMENDMENT OF INTERNAL REVENUE CODE.—Clause (ii) of section 411(a)(3)(D) (relating to withdrawal of mandatory contributions) is amended by striking out "any one-year break in

service" and inserting in lieu thereof "a period of 5 consecutive 1-year breaks in service".

(B) AMENDMENT OF ERISA.—Clause (ii) of section 203(a)(3)(D) of the Employee Retirement Income Security Act of 1974 is amended by striking out "any 1-year break in service" and inserting in lieu thereof "a period of 5 consecutive 1-year breaks in service".

(4) PARTICIPATION REQUIREMENTS UNDER SIMPLIFIED EMPLOYEE PENSIONS.—Subparagraph (A) of section 408(k)(2) (relating to participation requirements) is amended by striking out "age 25" and inserting in lieu thereof "age 21".

(b) AMENDMENTS RELATED TO SECTIONS 103 AND 203 OF THE ACT.—

(1) CLARIFICATION OF QUALIFIED PRERETIREMENT SURVIVOR ANNUITY IN CASE OF TERMINATED VESTED PARTICIPANT.—

(A) AMENDMENT OF INTERNAL REVENUE CODE.—Paragraph (1) of section 417(c) (defining qualified preretirement survivor annuity) is amended by adding at the end thereof the following new sentence:

"In the case of an individual who separated from service before the date of such individual's death, subparagraph (A)(ii)(I) shall not apply."

(B) AMENDMENT OF ERISA.—Paragraph (1) of section 205(e) of the Employee Retirement Income Security Act of 1974 (defining qualified preretirement survivor annuity) is amended by adding at the end thereof the following new sentence:

"In the case of an individual who separated from service before the date of such individual's death, subparagraph (A)(ii)(I) shall not apply."

(2) CLARIFICATION OF TRANSFEREE PLAN RULES.—

(A) AMENDMENTS OF INTERNAL REVENUE CODE.—

(i) Subclause (III) of section 401(a)(11)(B)(iii) (relating to plans to which requirements of joint and survivor annuity and preretirement survivor annunity apply) is amended by striking out "indirect transferee" and inserting in lieu thereof "indirect transferee (in a transfer after December 31, 1984)".

(ii) Subparagraph (B) of section 401(a)(11) is amended by adding at the end thereof the following new sentence:

"Clause (iii)(III) shall apply only with respect to the transferred assets if the plan separately accounts for assets and any income therefrom."

(B) AMENDMENTS OF ERISA.—

(i) Claue (iii) of section 205(b)(1)(C) of the Employee Retirement Income Security Act of 1974 is amended by striking out "a transferee" and inserting in lieu thereof "a direct or indirect transferee (in a transfer after December 31, 1984)".

(ii) Paragraph (1) of section 205(b) of such Act is amended by adding at the end thereof the following new sentence:

"Clause (iii) of subparagraph (C) shall apply only with respect to the transferred assets if the plan separately accounts for assets and any income therefrom."

(3) CLARIFICATION OF COORDINATION BETWEEN QUALIFIED JOINT AND SURVIVOR ANNUITY AND QUALIFIED PRERETIREMENT SURVIVOR ANNUITY.—

(A) AMENDMENT OF INTERNAL REVENUE CODE.—Clause (i) of section 401(a)(11)(A) is amended by striking out "who retires under the

plan" and inserting in lieu thereof "who does not die before the annuity starting date".

(B) AMENDMENT OF ERISA.—Paragraph (1) of section 205(a) of the Employee Retirement Income Security Act of 1974 is amended by striking out "who retires under the plan" and inserting in lieu thereof "who does not die before the annuity starting date".

(4) REQUIREMENT OF SPOUSAL CONSENT FOR USING PLAN ASSETS AS SECURITY FOR LOANS.—

(A) AMENDMENTS OF INTERNAL REVENUE CODE.—

(i) Paragraph (1) of section 417(a) is amended by striking out "and" at the end of subparagraph (A), by striking out the period at the end of subparagraph (B) and inserting in lieu thereof ", and", and by adding at the end thereof the following new subparagraph:

"(C) the plan provides that no portion of any participant's accrued benefit may be used as security for any loan unless the spouse of the participant (if any) consents in writing to such use."

(ii) Subsection (f) of section 417 is amended by redesignating paragraph (5) as

paragraph (6) and by inserting after paragraph (4) the following new paragraph:

"(5) DISTRIBUTIONS BY REASON OF SECURITY INTERESTS.—If the use of any participant's accrued benefit as security for a loan meets the requirements of subsection (c)(1)(C), nothing in this section shall prevent any distribution required by reason of a failure to comply with the terms of such loan."

(B) AMENDMENT OF ERISA.—

(i) Paragraph (1) of section 205(c) of the Employee Retirement Income Security Act of 1974 is amended by striking out "and" at the end of subparagraph (A), by striking out the period at the end of subparagraph (B) and inserting in lieu thereof ", and", and by adding at the end thereof the following new subparagraph:

"(C) the plan provides that no portion of any participant's accrued benefit may be used as security for any loan unless the spouse of the participant (if any) consents in writing to such use."

(ii) Section 205 of such Act is amended by redesignating subsection (j) as subsection (k) and by inserting after subsection (i) the following new subsection:

"(j) If the use of any participant's accrued benefit as security for a loan meets the requirements of subsection (c)(1)(C), nothing in this section shall prevent any distribution required by reason of a failure to comply with the terms of such loan."

(C) EFFECTIVE DATES.—

(i) The amendments made by this paragraph shall apply with respect to loans made after April 18, 1985.

(ii) In the case of any loan which was made on or before April 18, 1985, and which is secured by a portion of the participant's accrued benefit, nothing in the amendments made by sections 103 and 203 of the Retirement Equity Act of 1984 shall prevent any distribution required by reason of a failure to comply with the terms of such loan.

(iii) For purposes of this subparagraph, any loan which is revised, extended, renewed, or renegotiated after April 18, 1985, shall be treated as made after April 18, 1985.

(5) CLARIFICATION OF NOTICE REQUIREMENT FOR INDIVIDUALS HIRED AFTER AGE 35.—

(A) AMENDMENT OF INTERNAL REVENUE CODE.—Paragraph (B) of section 417(a)(3) (relating to plan to provide written explanations) is amended by striking out "in which the participant attains age 35" and inserting in lieu thereof "in which the participant attains age 35, or, if later, within a reasonable period after the participant is hired,".

(B) AMENDMENT OF ERISA.—Subparagraph (B) of section 205(c)(3) of the Employee Retirement Income Security Act of 1974 is amended by striking out "in which the participant attains age 35" and inserting in lieu thereof "in which the participant attains age 35, or if later, within a reasonable period after the participant is hired,".

(6) SPOUSAL CONSENT FOR CHANGES IN DESIGNATIONS.—

(A) AMENDMENT OF INTERNAL REVENUE CODE.—Subparagraph (A) of section 417(a)(2) (relating to requirement that spouse consent to election) is amended to read as follows:

"(A)(i) the spouse of the participant consents in writing to such election, (ii) such election designates a beneficiary which may not be changed without spousal consent (or the consent of the

spouse permits designations of beneficiaries by the participant without any requirement of further consent by the spouse), and (iii) the spouse's consent acknowledges the effect of such election and is witnessed by a plan representative or a notary public, or".

(B) AMENDMENT OF ERISA.—Subparagraph (A) of section 205(c)(2) of the Employee Retirement Income Security Act of 1974 is amended to read as follows:

"(A)(i) the spouse of the participant consents in writing to such election, (ii) such election designates a beneficiary which may not be changed without spousal consent (or the consent of the spouse permits designations of beneficiaries by the participant without any requirement of further consent by the spouse), and (iii) the spouse's consent acknowledges the effect of such election and is witnessed by a plan representative or a notary public, or".

(C) EFFECTIVE DATE.—The amendments made by this paragraph shall apply to elections made after the date of the enactment of this Act.

(7) CLERICAL AMENDMENTS.—

(A) Paragraph (1) of section 417(a) is amended by striking out "section 401(a)(ii)" and inserting in lieu thereof "section 401(a)(11)".

(B) Paragraph (1) of section 417(c) is amended by striking out "survivor annuity or the life of" in the matter preceding subparagraph (A) and inserting in lieu thereof "survivor annuity for the life of".

(C) Subparagraph (B) of section 415(b)(2) is amended by striking out "as defined in section 401(a)(11)(G)(iii)" and inserting in lieu thereof "as defined in section 417".

(c) AMENDMENTS RELATED TO SECTIONS 104 AND 204 OF THE ACT.—

(1) TREATMENT OF QUALIFIED DOMESTIC RELATIONS ORDERS FOR INDIVIDUALS OTHER THAN SPOUSE OR FORMER SPOUSE.—Paragraph (9) of section 402(a) (relating to alternate payee under qualified domestic relations ordered treated as distributee) is amended by striking out "the alternate payee shall be treated" and inserting in lieu thereof "any alternate payee who is the spouse or former spouse of the participant shall be treated".

(2) PROCEDURES FOR PERIOD DURING WHICH DETERMINATION BEING MADE.—

(A) AMENDMENTS OF THE INTERNAL REVENUE CODE.—

(i) Subparagraph (B) of section 414(p)(7) (relating to payment to alternate payee if ordered determined to be qualifed domestic relations) is amended—

(I) by striking out "18 months" and inserting in lieu thereof "the 18-month period described in subparagraph (E)", and

(II) by striking out "plus any interest" and inserting in lieu thereof "including any interest".

(ii) Subparagraph (C) of section 414(p)(7) is amended—

(I) by striking out "18 months" and inserting in lieu thereof "the 18-month period described in subparagraph (E)", and

(II) by striking out "plus any interest" and inserting in lieu thereof "including any interest".

(iii) Subparagraph (D) of section 414(p)(7) is amended by striking out "the 18-month period" and inserting in lieu there-

of "the 18-month period described in subparagraph (E)".

(iv) Paragraph (7) of section 414(p) is amended by adding at the end thereof the following new subparagraph:

"(E) DETERMINATION OF 18-MONTH PERIOD.—For purposes of this paragraph, the 18-month period described in this subparagraph is the 18-month period beginnig with the date on which the first payment would be required to be made under the domestic relations order."

(B) AMENDMENTS OF ERISA.—

(i) Clause (ii) of section 206(d)(3)(H) of the Employee Retirement Income Security Act of 1974 is amended—

(I) by striking out "18 months" and inserting in lieu thereof "the 18-month period described in clause (v)", and

(II) by striking out "plus any interest" and inserting in lieu thereof "including any interest".

(ii) Clause (iii) of section 206(d)(3)(H) of such Act is amended—

(I) by striking out "18 months" and inserting in lieu thereof "the 18-month period described in clause (v)", and

(II) by striking out "plus any interest" and inserting in lieu thereof "including any interest".

(iii) Clause (iv) of section 206(d)(3)(H) of such Act is amended by striking out "the 18-month period" and inserting in lieu thereof "the 18-month period described in clause (v)".

(iv) Subparagraph (H) of section 206(d)(3) of such Act is amended by adding at the end thereof the following new clause:

"(v) For purposes of this subparagraph, the 18-month period described in this clause is the 18-month period beginning with the date on which the first payment would be required to be made under the domestic relations order."

(3) COORDINATION WITH QUALIFIED PLAN REQUIREMENTS.—Section 401 is amended by redesignating the subsection relating to cross references as sub-

section (n) and by inserting after subsection (l) the following new subsection:

"(m) COORDINATION WITH QUALIFIED DOMESTIC RELATIONS ORDERS.—The Secretary shall prescribe such regulations as may be necessary to coordinate the requirements of sections 401(a)(13)(B) and 414(p) (and the regulations issued by the Secretary of Labor thereunder) with the other provisions of this chapter."

(4) CLERICAL AMENDMENTS.—

(A) AMENDMENTS OF INTERNAL REVENUE CODE.—

(i) Subparagraph (F) of section 402(a)(6) is amended by striking out "paragraph (5)(A)" and inserting in lieu thereof "paragraph (5)".

(ii) Clause (i) of section 414(p)(1)(B) is amended by striking out "to a spouse," and inserting in lieu thereof "to a spouse, former spouse,".

(iii) Clause (i) of section 414(p)(6)(A) is amended by striking out "any other alternate payee" and inserting in lieu thereof "each alternate payee".

(iv) Subparagraph (B) of section 414(p)(5) is amended by striking out "the

surviving spouse" and inserting in lieu thereof "the surviving former spouse".

(v) Subsection (p) of section 414 is amended by striking out the last sentence of paragraph (5), by redesignating paragraph (9) as paragraph (10), and by inserting after paragraph (8) the following new paragraph:

"(9) WAIVER OF CERTAIN DISTRIBUTION REQUIREMENTS.—

"(A) IN GENERAL.—With respect to the requirements of subsection (a) or (k) of section 401 which prohibit payment of benefits before termination of employment, a plan shall not be treated as failing to meet such requirements solely by reason of payments to an alternate payee pursuant to a qualified domestic relations order.

"(B) WAIVER APPLIES ONLY IF PRESENT VALUE OF PAYMENTS DOES NOT EXCEED $3,500.—Subparagraph (A) shall not apply with respect to payments to an alternate payee pursuant to a qualified domestic relations order if the present value of the payments to such payee pursuant to such order exceeds $3,500.

"(C) PRESENT VALUE.—For purposes of subparagraph (B), the present value shall be determined—

"(i) as of the date of the first payment to the alternate payee pursuant to such order, and

"(ii) by using an interest rate not greater than the interest rate which would be used (as of the date of such first payment) by the Pension Benefit Guaranty Corporation for purposes of determining the present value of a lump sum distribution on plan termination."

(B) AMENDMENTS OF ERISA.—

(i) Clause (ii) of section 206(d)(3)(F) of the Employee Retirement Income Security Act of 1974 is amended by striking out "the former spouse" and inserting in lieu thereof "the surviving former spouse".

(ii) Subclause (I) of section 206(d)(3)(G)(i) of such Act is amended by striking out "any other alternate payee" and inserting in lieu thereof "each alternate payee".

(d) AMENDMENTS RELATED TO SECTION 207 OF THE ACT.—

(1) Paragraph (1) of section 402(f) (relating to written explanation to recipients of distributions eligible for rollover treatment) is amended by striking out "qualified rollover distribution" and inserting in lieu thereof "eligible rollover distribution".

(2) Paragraph (2) of section 402(f) is amended to read as follows:

"(2) DEFINITIONS.—For purposes of this subsection—

"(A) ELIGIBLE ROLLOVER DISTRIBUTION.—The term 'eligible rollover distribution' means any distribution any portion of which may be excluded from gross income under subsection (a)(5) of this section or subsection (a)(4) of section 403 if transferred to an eligible retirement plan in accordance with the requirements of such subsection.

"(B) ELIGIBLE RETIREMENT PLAN.—The term 'eligible retirement plan' has the meaning given such term by subsection (a)(5)(E)(iv)."

(e) AMENDMENT RELATED TO SECTION 301 OF THE ACT.—Paragraph (1) of section 204(g) of the Employee Retirement Income Security Act of 1974 is amended by striking

out "section 302(c)(8)" and inserting in lieu thereof "section 302(c)(8) or 4281".

(f) AMENDMENTS RELATED TO SECTION 303 OF THE ACT.—

(1) Subsection (c) of section 303 of the Retirement Equity Act of 1984 (relating to transitional rule for requirement of joint and survivor annuity and preretirement survivor annuity) is amended by adding at the end thereof the following new paragraph:

"(4) ELIMINATION OF DOUBLE DEATH BENEFITS.—

"(A) IN GENERAL.—In the case of a participant described in paragraph (2), the amount of any death benefit (other than a qualified joint and survivor annuity or a qualified preretirement survivor annuity) payable to any beneficiary shall be reduced by the amount payable to the surviving spouse of such participant by reason of paragraph (2).

"(B) SPOUSE MAY WAIVE PROVISIONS OF PARAGRAPH (2).—In the case of any participant described in paragraph (2), the surviving spouse of such participant may waive the provisions of paragraph (2). Such waiver shall be made on or before the close of the first plan year to which the

amendments made by this Act apply. Such a waiver shall not be treated as a transfer of property for purposes of chapter 12 of the Internal Revenue Code of 1954 and shall not be treated as an assignment or alienation for purposes of section 401(a)(13) of the Internal Revenue Code of 1954 or section 206(d) of the Employee Retirement Income Security Act of 1974."

(2) Subparagraph (A) of section 303(e)(2) of the Retirement Equity Act of 1984 (relating to treatment of certain participants who perform services on or after January 1, 1976) is amended by striking out "in the first plan year" and inserting in lieu thereof "in any plan year".

SEC. 3. EFFECTIVE DATE.

Except as otherwise provided in section 2 of this Act, any amendment made by section 2 of this Act shall take effect as if included in the provision of the Retirement Equity Act of 1984 to which such amendment relates.

Chairman ROSTENKOWSKI. The committee will please come to order.

Today, the full committee is holding hearings on H.R. 1800, the Technical Corrections Act of 1985, and H.R. 2110, legislation making technical corrections to the Retirement Equity Act of 1984. The hearing covers a wide range of issues and we have a considerable number of witnesses to hear. Witnesses will be limited to 5 minutes. I urge everyone to comply with the time restrictions so that we may be able to hear from all of our guests.

Let me begin this hearing by reiterating my strong feeling that technical corrections legislation is not a vehicle for substantive changes. We do not meet today to hear from those who are merely dissatisfied with the legislation enacted in 1984, but rather to correct unintentional errors and to make necessary clarifications. I will continue to apply a high definitional standard to each proposed technical amendment and note once again that advocates of additional changes are required to carry that burden.

Our first witness today will be Roger Mentz, Deputy Assistant Secretary for Tax Policy. I understand this is your first official appearance before the full committee. I welcome you and I look forward to working with you in the future.

Mr. Mentz, you may proceed in any manner you wish.

STATEMENT OF J. ROGER MENTZ, DEPUTY ASSISTANT SECRETARY FOR TAX POLICY, U.S. DEPARTMENT OF THE TREASURY

Mr. MENTZ. Thank you, Mr. Chairman.

It is indeed a pleasure to be here for my first appearance before this committee in my capacity as Deputy Assistant Secretary of the Treasury. I have previously appeared before this committee in my capacity as a private practitioner and as chairman of the New York State Bar Association, but it is indeed an honor to be here in my present capacity.

The Tax Reform Act of 1984 had an extremely broad scope. It touched virtually every area of the U.S. tax law and its provisions are being felt today in the marketplace where transactions are being done and I believe the effect is very much along the lines intended by Congress when the act was passed. It is, however, a very complex statute and indeed the private bar is somewhat close to an overload situation in terms of complexity. There are not too many private practitioners who are fully conversant with all the provisions of the Tax Reform Act, and I am not one of them, so if there are questions about any provisions of the Tax Reform Act, I will try to answer them, but you should be prepared for some "I don't know answers."

I think that we should have in mind the complexity as we move forward, hopefully soon, to other tax legislation in this Congress and bear in mind that we do have this complexity problem as we proceed with tax legislation.

On the subject of the Technical Corrections Act, let me say that the act itself being so complex, it was inevitable that there be some technical corrections and indeed I think the scope of the Technical Corrections Act is really quite modest considering the breadth of the Tax Reform Act of 1984. I think that is a credit to the persons

who participated in the preparation and enactment of the Tax Reform Act of 1984.

The Treasury Department has virtually no objection to most of the provisions of the Technical Corrections Act.

What I will do with your permission, Mr. Chairman, is to address only those provisions that the Treasury either has a problem or a question with, and I will do it in the order that the provisions appear in the bill.

My written testimony fully explains the Treasury position and I am not going to read that. I am going to hit the highlights of the important points.

Chairman ROSTENKOWSKI. Mr. Secretary, without objection, your entire statement will be included in the record. If you would like to summarize, please do.

Mr. MENTZ. Thank you very much.

The first area that I would like to touch on is the dividends received deduction provision of the Technical Corrections Act. A corporation is entitled to an 85- or 100-percent dividend received deduction with respect to dividends paid by another corporation. The deduction is intended to avoid the double taxation of earnings at the corporate level.

The dividends received deduction is not allowed if a statutory holding period requirement is not satisfied. The holding period requirement was generally 15 days under prior law. It was increased by the Tax Reform Act to 45 days. The reason for the holding period requirement is so that a dividend is not received tax free and then the corporation turns around and sells the stock and is entitled to a deductible capital loss. In order to make that rule work, there is a provision in the statute that the holding period does not include periods during which there is a put or a contract to sell the stock that the corporation is holding. That creates—has created under current law, even before the Tax Reform Act, some question as to how the law operated where there was, let's say, a put that was held by the corporation but not exercised.

The general administrative practice was that if a put wasn't exercised, the dividends received deduction was available. However, because of the ambiguity, the Technical Corrections Act proposes to change that result and provide that if there is a put or a contract to sell the stock that is in existence for any period of time, that whether or not the stock is disposed of, the dividends received deduction is not allowable if the holding period requirement is not satisfied.

It is our position, Mr. Chairman, that this is too tough a rule and that it would adversely affect legitimate transactions where a corporation owns stock of another corporation and in a purely normal business-motivated transaction, buys a put in order to protect itself against downside risk, but continues to hold the stock. If it continues to hold the stock and doesn't sell the stock, we believe that the right answer is that the dividends received deductions should not be forfeited. That is a suggestion for a change in the Technical Corrections Act that the Treasury has.

Maybe the best procedure is to see if there are any questions as I proceed from item to item rather than holding all the questions for the end.

Is that acceptable, Mr. Chairman, if I am asked questions on each subject?

Chairman ROSTENKOWSKI. Mr. Mentz, as you know, the Technical Corrections Act amends code section 246(c)(1)(A). This particular amendment is effective for transactions entered into after July 18, 1984, the date of enactment of the Deficit Reduction Act of 1984.

We have been asked to consider making this amendment prospective, so that it would not be effective before the date of enactment of the Technical Corrections Act of 1985. What is your view on that?

Mr. MENTZ. We agree with the suggestion that it should be prospective only. We would suggest that the amendment in its present form is inappropriate and needs modification, as I hope just testified. But on the effective date, we concur 100 percent.

Chairman ROSTENKOWSKI. Thank you. The Chair would like to state its views that in order to allow transactions to proceed in reliance on current law, the effective date of the code 246(c)(1)(A) should be made no earlier than the date of enactment of the technical corrections bill.

Are there any questions of Mr. Mentz?

Mr. GIBBONS. Let me ask him some questions generally. I want to talk to him about the withholding.

Mr. MENTZ. I was going to address that at a later point, Mr. Gibbons.

Mr. GIBBONS. Go right ahead.

Chairman ROSTENKOWSKI. Please proceed, Mr. Mentz.

Mr. MENTZ. Mr. Chairman, what I suggested was that I stop and take questions at every point if that is acceptable, but I will do it any way you want.

Chairman ROSTENKOWSKI. If you will conclude your statement in its entirety, then we will ask further questions.

Mr. MENTZ. Fine. We will do it that way.

Hitting the highlights, Mr. Chairman, there is a change in the effective date of the so-called multiple trust rule. That is a rule enacted in the Tax Reform Act that provides that multiple trusts set up by basically the same grantor with the same beneficiaries are to be consolidated if there is a tax avoidance purpose for taxable years beginning after March 1984.

That rule would be basically pretty well gutted by a provision in the Technical Corrections Act that would effectively grandfather all trusts previously created except for additional contributions to the corpus of those trusts, and the Treasury objects to that modification.

It is really not a technical correction and it dramatically changes the impact of the multiple trust rule as enacted by Congress in 1984.

I am going to skip a couple of issues that are, I believe, hypertechnical and move on to some of the more substantial ones.

There is a question of the definition of "welfare benefit fund." As you may recall, last year Congress dealt with the subject of voluntary employee beneficiary associations in a way to limit the tax benefits that were considered abusive and the scope of the amendment keys off of the definition of "welfare benefit fund."

That definition includes an authority to prescribe regulations dealing with insurance company arrangements that essentially provide the same type of benefit. The proposal has been made in the Technical Corrections Act "welfare benefit fund" in the context of insurance arrangements.

The Treasury's position is that we do not feel that there has been sufficient study and understanding of the technical problems involved in that definition, and that rather than define it in this statute before the opportunity is available to make a full and complete study, that the matter be left for Treasury regulations with the exception, that the statute would be amended to provide that except with respect to certain arrangements that we could all agree commonly would be considered to be funds, any other arrangements would not be considered welfare benefit funds until 6 months after final regulations are prescribed.

That would avoid the so-called chilling effect on the insurance industry of an uncertainty as to this definition. We think that that is a fair way of dealing with it in a way that does not adversely affect the insurance industry, and yet preserves the ability to study this issue in more depth, which is clearly required.

We have a proposal on employer-operated heating facilities. Presently, the code provides that if an employer has a cafeteria, it is de minimis fringe, as long as the employer is not subsidizing the cafeteria. However, most employer cafeterias are subsidized. Therefore, the literal language of the statutory exception does not apply and the fair market value of the food provided to all the employees is taxable.

To figure out which employee had what for lunch and how much of a value should be taxable is an impossible burden, and it is leading the IRS into the same scenario that they were in on the recordkeeping and automobile log problem that Congress had to rescue them from.

So rather than try to impose a rule that is administratively very difficult, if not impossible, our suggestion is that if there is a subsidized cafeteria, exempt the employees from tax but provide a surrogate tax on the employer, an excise tax based on the subsidy.

Perhaps you might have a different excise tax depending upon whether the cafeteria was discriminatory in favor of the high-paid people or not. The theory would be if it was favoring the high-paid people, the chances are they are in a higher income tax bracket so it would make sense for the surrogate tax to be higher.

But the idea is there should be a tax payable, but let's not impose it on the employees because it is administratively impossible. Let's find a way to put it on the employer.

Mr. GIBBONS. Would that apply to the Senate dining room?

Mr. MENTZ. I don't know. I haven't thought about that.

Mr. GIBBONS. You'd better. That is what they do over there.

Mr. MENTZ. Well, if you applied it that way, you would have to tax the U.S. Government as the employer, which wouldn't make much sense. I guess you would need an exemption.

Mr. GIBBONS. You have to be consistent.

Mr. MENTZ. That is right. That is a valid point.

The last subject I would like to address, and I know this is a subject of interest to you, Mr. Gibbons, is the subject of 30-percent withholding and Eurodollar borrowing by American corporations.

I could undoubtedly tell this committee much more than you would like to hear about the subject of Eurodollar financing, but I will summarize quickly.

Over the past 20 years, the U.S. Government has had a policy generally of encouraging U.S. corporations to borrow in the Eurodollar market. That market is fundamentally dollars on deposit in countries outside the United States and there is a market, a very large market, for U.S. corporate obligations.

The market may be divided generally between private and public securities, and over the course of the last 20 years, as you well know, Mr. Gibbons, the United States has had different policies, but they were all intended to permit access to that market without imposition of withholding tax.

In the 1960's, we had a published ruling policy that permitted Netherlands Antilles financing subsidiaries to borrow directly in the Eurodollar market, covering public and private offerings. In the early 1970's, we had a direct exemption for U.S. companies to issue publicly issued securities to the Eurodollar market without withholding tax.

From about 1974, when the interest equalization tax expired, we have had a kind of de facto policy that did not preclude U.S. companies from borrowing in that market, but it had to be done through the Netherlands Antilles finance subsidiaries and was a cumbersome method to facilitate borrowing and required paying Netherlands Antilles tax. It was an impractical arrangement and one that quite properly Congress departed from in 1984.

Now, the question that I would like to address is the scope of the withholding tax exemption under the Tax Reform Act of 1984.

The exemption, I think, may be read literally, as enacted in 1984, to cover basically just about any kind of security, public, private, even a trade receivable. For example, a U.S. purchaser buys equipment from, let's say, a Japanese manufacturer, gives him a note; the note is payable later than 6 months and bears interest. It is at least arguable that there is no 30-percent withholding—the rate would be lower than 30 because of the treaty—that the taxpayer could take a position that the withholding tax doesn't apply to that transaction.

Similarly, the statute could be read to apply the exemption from withholding to private issuance of securities as well as clearly public offerings.

Now, I would suggest that a reasonable approach for the U.S. Government to take, Mr. Chairman, with regard to the scope of the exemption, would be to look at what you are trying to accomplish by the 30-percent withholding repeal. You absolutely have to have repeal in a public offering. If you have any kind of withholding tax, a public offering would simply not be possible. This is because the buyers require that the obligations be in a bearer form and not subject to withholding tax. The borrower would have to make up the withholding taxes, and you know that in that case, it is impossible; the economics just don't merit it.

So basically, for a public issue, there is no question that you have to have an exemption. That has been in U.S. policy for the last 20 years.

By the way, I should, as a footnote, add that some transactions in the Eurodollar market which may be couched as private transactions ultimately are public. They are sales to Swiss banks which are resold in what we would consider to be a public offering to purchasers that, under Swiss law, might be considered private. But we would consider them to be public offerings. Certainly I would include that in my concept of what is a public offering.

In the private placement area, however, it is a little bit different. A U.S company, large or small, is able to borrow from a European institution, whether it is an insurance company or any kind of an institution, without necessarily providing an unlimited exemption from withholding. It may borrow from a U.K. insurance company, for instance—the treaty rate is zero, negotiated to be zero—and there is no withholding.

So the U.S. company, large or small, that wishes to tap the Eurodollar pool of capital is able to do so in a private placement even though the obligation is not unilaterally exempt from withholding tax.

It is true that the U.K. pension fund would prefer the obligation to be unilaterally exempt from tax. And the reason for that is they may want to lay it off to a third country investor who doesn't have a treaty with the United States, so the paper is more valuable if it is not subject to withholding in any case.

But the point that I am making is, exemption from withholding tax is not a sine qua non for borrowing Eurodollars in private placement as it is in a public offering.

The Treasury feels that there is an advantage to not granting a blanket exemption from withholding to trade payables and to private placements. The advantage is that it preserves the ability to negotiate in a treaty context what the withholding tax rate is to be.

If we can negotiate with another treaty partner and the rate is zero, fine. But if we give the bargaining chip away unilaterally, that is a give-up that the Treasury would prefer to avoid.

Other jurisdictions, most other jurisdictions, when they have withholding tax exemptions, provide them primarily for public offerings, generally not for private placements, although there are some that do it for all. I believe that Japan——

Mr. GIBBONS. What you are doing is asking us to come back under the guise of technical corrections and make the law.

Mr. MENTZ. I started off by saying that I think a taxpayer can fairly construe the law as written to say that it applies to all interest. I am raising the point——

Mr. GIBBONS. That was my intent, and I am the author of the bill.

Mr. MENTZ. I am aware of that. I am simply raising the point that perhaps that is not where the United States wants to be. If it is, then that is the will of Congress.

Mr. GIBBONS. You want to change the law and bring it back here, and let's discuss it. Let's don't change it under the guise it is just a Treasury regulation interpretation of intent.

I know what the intent was. I am the author of the bill, and I had better not catch you changing the law surreptitiously. I am telling you that flatly.

I am sick and tired of us passing a law and you writing it the way you want to. Let's get that square right now.

Mr. MENTZ. That is absolutely square. I am not going to change the law, but I am recommending a change.

Mr. GIBBONS. It is not just a little technical correction. Don't call it that.

[The prepared statement follows:]

STATEMENT OF J. ROGER MENTZ, DEPUTY ASSISTANT SECRETARY (TAX POLICY), DEPARTMENT OF THE TREASURY

Mr. Chairman and members of the committee, it is my pleasure to present the views of the Treasury Department on H.R. 1800, the Technical Corrections Act of 1985, and H.R. 2110, a bill making technical corrections to the Retirement Equity Act of 1984.

The Tax Reform Act of 1984 had an extremely broad scope, touching virtually every area of U.S. tax law, including time value of money tax accounting, corporate and partnership taxation, and the taxation of employee benefits, tax-exempt bonds, life insurance, private foundations, and international business. The Tax Reform Act also included significant changes directed at simplification of the Code, as well as provisions as diverse as those involving luxury cars and the excise tax on sport fishing equipment. The Retirement Equity Act of 1984 brought major changes to the treatment of pensions and other retirement benefits.

Considering the scope and complexity of the Tax Reform Act and the Retirement Equity Act, technical corrections acts seemed inevitable. Nevertheless, the two technical corrections bills as presently drafted and introduced provide a relatively modest number of technical corrections—this is a compliment to the skills of the persons involved in the preparation and passage of the Tax Reform Act and the Retirement Equity Act.

The Treasury Department supports virtually all of the proposed amendments included in the bills. We will discuss in the order in which they appear in the bills those few provisions that we oppose or that we believe require modification or, at least, amplification. In addition, we will discuss several areas included in the Tax Reform Act that are not the subject of any provisions in the bills, but which we believe require technical correction.

TECHNICAL CORRECTIONS ACT OF 1985

Dividends received deduction

Section 104(b)(1) of the bill would amend the holding period requirements applicable to stock owned by corporations claiming the dividends received deduction. The corporate dividends received deduction is provided under current law to limit the imposition of multiple taxation as dividends are paid by one corporation to another corporation. Under present law, corporate income generally is subject first to the corporate income tax and then to a shareholder level tax when the corporate earnings are distributed as dividends to noncorporate shareholders. The dividends received deduction provides the mechanism to ensure that significant additional corporate level tax is not imposed on intermediate distributions of earnings to corporate shareholders.

Under current law, however, the dividends received deduction is not allowed with respect to any dividend on any share of stock which is sold or otherwise disposed of in any case in which the taxpayer has not held such share for a specified time period, or to the extent that the taxpayer is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in related property. These limitations were originally enacted in 1958 to deny a dividends received deduction in certain cases in which so-called tax arbitrage opportunities exist.

Generally, the price of a share of stock drops immediately after the stock becomes "ex-dividend," because the holder of the stock on the ex-dividend date, rather than the transferee, is entitled to receive the dividend. Absent a holding period requirement, a corporate taxpayer could acquire shares immediately prior to the date shares become ex-dividend and, following the ex-dividend date when the value of the

shares has dropped by an amount approximately equal to the anticipated dividend, the corporation could sell the shares at a loss. In such case, often called "dividend stripping," the corporate shareholder could claim the dividends received deduction with respect to the dividend, thereby making the dividend income almost tax-exempt, and could utilize the short-term capital loss resulting from the sale of the shares to offset against capital gain income.

As originally enacted, the required holding period was 16 days (91 days in the case of certain preferred dividends). The market risks associated with holding the shares for those periods were viewed as adequate to deter taxpayers from engaging in the tax-motivated transaction described above. The 16-day and 91-day holding periods, however, did not include periods during which the taxpayer reduced or eliminated the risk of loss on the underlying stock by entering into a short sale of, acquiring an option to sell, or entering into a binding contract to sell, substantially identical stock or securities. Such transactions could be utilized to "lock in" the sales price of stock and allow a corporate taxpayer to engage in dividend stripping with respect to a dividend payment, regardless of the period the stock is held.

For example, if stock is purchased immediately before the ex-dividend date at $100, a $10 dividend is declared with respect to the stock, and the taxpayer buys an option to sell the stock for $90, the taxpayer exercising the option is assured of a sales price equivalent to the fair market value immediately after the ex-dividend date, regardless of subsequent market movements affecting the value of the stock. Under current law, the dividends received deduction would be denied with respect to the $10 dividend to prevent such an abusive transaction. If the option is not exercised and the stock is not otherwise disposed of, however, no loss is recognized, the option has not provided the taxpayer with a tax arbitrage opportunity, and there is no reason to deny a dividends received deduction with respect to the $10 dividend.

A similar abuse exists in cases where a corporate taxpayer holds both "long" and "short" positions with respect to stock on the ex-dividend date. Absent a rule denying the dividends received deduction with respect to dividends received when an obligation to make corresponding payments exists regardless of whether a sale or other disposition occurs, a corporate taxpayer would claim that all of the dividends received with respect to the stock are subject to the dividends received deduction, while also deducting against ordinary income the amounts paid (generally equal to the dividends received) with respect to the short position.

The corresponding payment rule as originally enacted was limited to payments made with respect to short positions in "substantially identical stocks or securities." Because taxpayers were attempting to circumvent the statutory rules by acquiring dividend-paying common stock and entering into short sales of convertible preferred stock or convertible bonds of the same issuer and claiming that the positions were not "substantially identical," the Tax Reform Act expanded the corresponding payment rule to include payments made with respect to short positions in substantially similar or related property. In addition, the holding period requirement was extended from 16 days to 46 days, because Congress determined that the 16-day requirement was inadequate to deter dividend stripping (the 91-day holding period for certain preference dividends was retained). Further, the Tax Reform Act provides regulatory authority for the suspension of the holding period with respect to stock for any day the taxpayer has diminished the risk of holding the stock by holding one or more other positions with respect to substantially similar or related property. The Tax Reform Act, however, did not change the requirement that a sale or other disposition occur before the dividends received deduction would be disallowed for failure to satisfy the requisite holding period.

The proposed amendment, contained in section 104(b)(1) of the bill, would disallow the dividends received deduction where the holding period requirement is not met, irrespective of whether there is a sale or disposition of the stock. According to the "Description of the Technical Corrections Act," prepared by the staff of the Joint Committee on Taxation, this provision is intended to eliminate perceived administrative problems caused by the disposition requirement. In particular, present law does not indicate clearly whether the dividends received deduction is denied retroactively to all dividends received with respect to stock that is sold or disposed of before the required holding period is satisfied or whether the dividends received deduction is denied only with respect to the last dividend received prior to the sale or other disposition of the stock. If the former interpretation were to prevail, as assumed by the Joint Committee staff explanation, significant administrative burdens would clearly arise.

We believe that the statute as presently drafted does not provide explicit guidance concerning which dividends are denied the dividends received deduction upon the sale or other disposition of stock before the required holding period is satisfied. The

policy underlying the dividends received deduction, however, suggests that present law should be interpreted to deny the dividends received deduction only with respect to dividends that provide the taxpayer with tax arbitrage opportunities. If corresponding payments are not made with respect to a short position in similar or related property, tax arbitrage opportunities are present only when there is a sale or disposition of the stock.

Under the proposed amendment, however, a corporation would be denied the dividends received deduction for all dividends received with respect to shares in a subsidiary or other corporation if the corporation has diminished its risk of loss by holding substantially similar or related property, regardless of whether the stock is held for 20 days or 20 years. While this result is appropriate and required by current law if the corporation also is making corresponding payments with respect to a short position in similar or related property, it is not appropriate in situations where only one dividend payment provides a tax arbitrage opportunity. Therefore, the proposed amendment does not further or clarify the Congressional purpose underlying the holding period requirement applicable to the dividends received deduction. Moreover, the proposed amendment, which would apply retroactively to stock the holding period for which began after the date of enactment of the Tax Reform Act, would impact significantly on corporations that enter into transactions to enhance yield and reduce the risk of market fluctuations with respect to stock held for long-term investment purposes.

In summary, we oppose the proposed deletion of the sale or other disposition requirement with respect to the dividends received deduction. We are not persuaded at this time that risk reduction absent tax arbitrage opportunities is a relevant criterion for purposes of denying the dividends received deduction. If the Committee decides that some action in this area is necessary, however, we suggest that, rather than the approach adopted in the bill, consideration should be given to reducing a corporate taxpayer's basis in acquired shares, in a manner similar to that provided in section 1059, if the taxpayer does not hold the shares for the required period.

Multiple trust rule

The Tax Reform Act provides that under Treasury regulations two or more trusts shall be consolidated and treated as one trust if (1) the trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries and (2) a principal purpose of the trusts is tax avoidance. The multiple trust rule is effective for taxable years beginning after March 1, 1984. Thus, it applies to existing trusts in taxable years beginning after March 1, 1984.

Although the bill would leave the substantive portion of the multiple trust rule intact, it would amend the effective date of the provision. In particular, section 106(a) of the bill provides that, in the case of any trust that was irrevocable on March 1, 1984, the multiple trust rule would apply only to the portion of the trust, if any, attributable to contributions made to corpus after March 1, 1984.

Prior to 1983, Treasury regulations provided that two or more trusts would be consolidated and treated as one trust under enumerated circumstances similar to the provisions of the multiple trust rule included in the Tax Reform Act. The Tax Court, however, held in 1983 that the Treasury regulations were invalid. In response to the Tax Court's decision, the multiple trust rule was enacted in the Tax Reform Act. Congress was concerned that, without the restrictions provided by the Treasury regulations, it would have been possible under the progressive tax rate structure for a taxpayer to reduce income taxes significantly by establishing multiple trusts for the same or similar beneficiaries. Congress sought to restrict this ability to reduce tax liability by expressly providing a statutory multiple trust rule.

We oppose the provision in the bill that would amend the effective date of the multiple trust rule for two reasons. First, the proposed amendment, in the Treasury Department's view, cannot be considered a technical correction. Rather, the amendment seeks to make a significant substantive change in the scope of the multiple trust rule. As enacted, the provision can operate to consolidate multiple trusts established before March 1, 1984, in the first taxable year beginning after that date. The proposed amendment would drastically reduce the number of trusts to which the provision is potentially applicable. Regardless of whether a broad grandfather rule would have been desirable in the provision as enacted, such an amendment cannot fairly be characterized as a technical correction.

Second, we believe the proposed amendment is overbroad. It must be recognized that the multiple trust rule can operate to consolidate two or more trusts for tax purposes only if, in addition to other requirements, a principal purpose of the trusts is tax avoidance. Accordingly, the proposed change in the effective date provision will provide relief only to trusts established with tax avoidance as a principal pur-

pose. In particular, the amendment would permit taxpayers who established an unlimited number of trusts prior to March 1, 1984 to continue to reduce their tax liability significantly in all future taxable years.

While the Treasury Department is aware of certain classes of trusts for which relief from application of the multiple trust rule might be appropriate, we believe an amendment providing wholesale relief to all trusts created prior to March 1, 1984, many of which may be flagrant attempts artificially to reduce tax liability, is improper and should not be included in the bill. We believe that any unjustified applications of the multiple trust rule can be avoided administratively. Nevertheless, we would be pleased to work with the Committee in drafting a narrower grandfather provision, if the Committee believes such relief should be provided by statute.

Definition of section 38 property

In an attempt to simplify the statutory formulation of the definition of new section 38 property, the Tax Reform Act inadvertently deleted the provision of section 48(b) stating that new section 38 property included certain reconstructed property. Reflecting the fact that no substantive change was intended, section 109(d) of the bill attempts to correct the mistake by providing that new section 38 property "includes any section 38 property the reconstruction of which is completed by the taxpayer."

The Treasury Department supports the effort to reinstate the provision that new section 38 property may include reconstructed property. In our view, however, the proposed amendment as drafted may mistakenly be interpreted to allow the investment credit for the entire basis in the reconstructed property, rather than the portion of the basis attributable to the reconstruction. Accordingly, we believe that section 109(d) of the bill should simply reinstate verbatim the original language of section 48(b), instead of revising the provision. Such a formulation is the best means to accomplish the intended result of restoring the law to its prior state.

Definition of listed property

The Tax Reform Act imposed stricter recordkeeping requirements and limited accelerated cost recovery (ACRS) deductions and investment tax credit (ITC) allowances on "listed property." The term "listed property" includes passenger automobiles and other means of transportation, computers and peripheral equipment, property used for entertainment, recreation and amusement purposes and other types of property specified in Treasury regulations. Computers that are "used exclusively at a regular business establishment," however, are not listed property.

Section 112(e)(3) of the bill would provide that the exception for computers used exclusively at a regular business establishment would apply only to computers "owned or leased by the person operating such establishment." Although this provision is consistent with the legislative history of the Tax Reform Act, the Treasury Department opposes this amendment because it is contrary to the purposes of the underlying provision.

The proposed amendment will primarily affect computers owned by employees that are kept at the employer's place of business. If an employee's computer kept at the employer's place of business is classified as listed property, the employee must substantiate claimed business use of the computer under section 274(d) of the Code (rather than section 162 of the Code) and prove that the computer is for the convenience of the employer and is required as a condition of employment to be entitled to any deduction or credit for the computer. Congress imposed these additional requirements on listed property because of concerns that taxpayers were overstating deductions for property of a type that is susceptible to personal use. These concerns were particularly acute in the case of employees claiming deductions for property used in connection with their employment.

The original exclusion for computers kept at a regular business establishment reflected a judgment that the potential for personal use of such property is minimal. The Treasury Department believes this rationale applies equally whether a computer is owned by an employer or an employee. The compliance concerns that prompted Congress to enact stricter limits on listed property are not likely to be as great when an employee keeps a computer at the employer's place of business. Therefore, we recommend that this proposed amendment be deleted from the bill.

Gambling activities conducted by nonprofit organizations

Section 511 of the Code imposes a tax on the income derived by a tax-exempt organization from the conduct of an "unrelated trade or business." An unrelated trade or business is defined as a trade or business the conduct of which is unrelated to the purpose for which the organization has been granted exemption from Federal income tax. The Tax Reform Act provides that the term "unrelated trade or busi-

ness" does not include conducting any game of chance by a nonprofit organization if (i) the organization's conduct of the game does not violate any State or local law, and (ii) as of October 5, 1983, there was a State law in effect that permitted the game of chance to be conducted only by nonprofit organizations. We understand that this provision was intended to apply only to gambling activities regularly conducted by nonprofit organizations located in North Dakota.

The Treasury Department opposed enactment of this provision as an inappropriate exception to the statutory definition of the activities that constitute an unrelated trade or business. Moreover, the Treasury Department did not believe it appropriate to enact a change in the substantive law that would apply to organizations located in one particular State without extending the special exemption to similarly situated organizations located in other States.

We understand that, since enactment of the Tax Reform Act, questions have arisen concerning whether this provision applies to States other than North Dakota. Section 133 of the bill would clarify Congressional intent by providing that the special exemption from the general rules defining an unrelated trade or business is available only if the State law restricting the operation of the particular game of chance to nonprofit organizations was originally enacted on April 22, 1977, the date the relevant law was enacted in North Dakota.

Given the Congressional intent to limit this provision of the Tax Reform Act solely to North Dakota, we agree that section 133 of the bill is within the proper scope of a technical corrections bill. We continue to believe, however, that the substantive provision is not a justifiable exception to the unrelated business income tax and that, in any event, the same rule should apply to all similarly situated taxpayers regardless of the State in which they are located. Finally, we note that under the general effective date provision of the bill the proposed amendment would apply as if it had been included in the Tax Reform Act. As described above, however, the provision as enacted applied on its face to nonprofit organizations located in any State in which a proper law was in effect as of October 5, 1984. Because nonprofit organizations located in States other than North Dakota with such laws in effect had no notice that the special exemption did not apply to them, transition rules providing appropriate relief should be adopted if the proposed amendment is enacted.

Definition of "welfare benefit fund"

Section 151(a)(8) of the bill proposes to amend the definition of "welfare benefit fund" to exclude certain experience-rated arrangements between employers and insurance companies so that employer contributions to, reserves under, and refunds and dividends paid pursuant to such arrangements will not be subject to the various limitations on "welfare benefit funds" enacted by the Tax Reform Act. The general policy underlying these limits was to restrict the extent to which employers are able currently to accumulate amounts on a tax-favored basis in "welfare benefit funds" to provide future benefits to employees. (These limitations are commonly known as the "VEBA" rules.)

We oppose the proposed amendment and instead recommend that the original decision of Congress on this issue—that such arrangements be treated as "welfare benefit funds" only to the extent provided in Treasury regulations—be permitted to stand. Under the proposed amendment, insurance companies might gain a substantial advantage in competing for employers' dollars to provide welfare benefits to employees.

The Tax Reform Act generally limited the favorable tax treatment of funds providing welfare benefits to active employees by precluding the employer from currently deducting contributions to a "fund" to provide future benefits to active employees and by subjecting fund income to unrelated business income tax where the fund's reserves at year-end are in excess of actuarially justified levels to cover claims incurred but unpaid as of the end of such year. Certain modifications to these rules were made where an employer is accumulating amounts to provide postretirement life insurance or health benefits to employees. The Tax Reform Act also provided that if any portion of a welfare benefit fund reverts to the benefit of the employer maintaining the fund, the amount of the reversion is subject to a 100 percent tax.

The Tax Reform Act contained a three-prong definition of the term "fund." First, any social club, voluntary employees' beneficiary association, supplemental unemployment compensation benefit trust, or group legal services organization that is tax-exempt is a "fund." Second, any trust, corporation, or other organization not exempt from income tax is a "fund"; this rule was directed at taxable trusts and similar organizations.

Third, and most important for present purposes, the Tax Reform Act provided that "to the extent provided in regulations, any account held for an employer by any person" would be a "fund." This third prong was directed principally at accounts held by insurance companies whereby the insurance company effectively holds an employer's funds on a tax-favored basis to discharge the employer's future welfare benefit obligations. This arrangement enables the employer to gain the benefit of the favorable tax treatment provided to insurance company reserves.

Even though no regulations have been issued causing any account involving an insurance company to be treated as a "fund" under the third prong of the definition, section 151(a)(8) of the bill proposes to amend the third prong to exclude certain amounts held for the benefit of an employer by an insurance company if (i) there is no guarantee of a renewal of the contract and (ii) the only payments to which the employer or employees are entitled, other than current insurance protection, are experience-rated refunds or policy dividends that are not guaranteed and that are determined based upon factors other than the amount of the welfare benefits paid to (or on behalf of) the employees of the employer. The bill would make this exemption contingent on the employer including any experience-rated refund or policy dividend with respect to a policy year in income in the employer's taxable year in which the policy year ends.

The proposed amendment would exempt certain experience-rated arrangements with insurance companies from the "fund" definition. Under a typical experience-rated arrangement involving health benefits, for example, the employer is assured of receiving in some form the benefit of the excess of premiums or contributions for a year of coverage over health claims paid with respect to such employer for such year (plus associated administrative expenses). The assurance given to the employer generally is not in the form of an express guarantee or a contractual entitlement. Moreover, some or all of the excess may be paid to the employer as a refund or policy dividend, used to reduce the required premiums or contributions for subsequent years of coverage, or credited to a reserve (such as a premium stabilization reserve) for the future benefit of the employer. The amendment would exempt experience-rated arrangements to the extent that there is a significant risk, due to factors other than the employer's own experience under the arrangement, that the employer will not receive the benefit of the excess premiums or contributions. We oppose the proposed amendment to the definition of "fund" for several reasons.

First, the question of whether an account involving an insurance company should be treated as a "fund" or whether an employer's arrangement with an insurance company is bona fide insurance is a complex policy issue that requires much more in-depth study than has been undertaken or is likely to be undertaken in the context of a technical corrections bill.

The Tax Reform Act provided that accounts involving insurance companies would be "funds" only to the extent provided in regulations because Congress and Treasury recognized that the related issues could be properly resolved only after an intensive examination of the various arrangements offered by insurance companies. The Treasury Department has only begun its examination of the extent to which employer's arrangements with insurance companies should be treated as "funds." In this connection, we have encountered some reluctance on the part of insurance companies to share their refund and dividend formulas with us so that we can properly evaluate these arrangements. Thus, we are not certain whether the proposed amendment either focuses on the appropriate factors or draws the proper distinctions. In this regard, we understand that certain insurance companies are now proposing modifications to the proposed amendment, indicating further the complexity of the issues and the importance of acting only after a complete examination.

We are sensitive to the concerns of the insurance companies that the definition of "fund" not be overbroad. We are similarly concerned, however, that the definition not be too narrow. An inappropriate narrowing of the scope of the enacted limits may effectively permit insurance companies to offer arrangements and associated tax advantages to employers that the employers are not able to obtain on a self-funded or self-insured basis and thus may create significant competitive advantages for insurance companies over self-insured arrangements. Given the magnitude of the market for employees' welfare benefits, such as life insurance and health benefits, this possibility has serious implications. Thus, we strongly believe that the most prudent course is not to enact the proposed amendment but rather to stand by Congress' original intention and permit the Treasury Department to examine the area more fully and issue regulations properly defining the operative terms.

Second, we understand that the primary objection raised by insurance companies to treating certain experience-rated arrangements as "funds" is that a refund or policy dividend would be a reversion subject to a 100 percent excise tax. We concede

that the language of the reversion tax provision may be read to apply to reasonable and bona fide premium refunds and policy dividends. However, such payments are not within the scope of the original policy underlying the reversion tax. Thus, we would not object to amending the excise tax provision to clarify that reasonable and bona fide premium or contribution refunds and policy dividends, if taken into income by the employer in the year to which the refund or dividend relates, would be exempt from the 100 percent reversion tax.

Third, we understand that insurance companies are further concerned that if an employer's employees have better-than-expected experience under an arrangement (such as a health benefit arrangement) for a year, premium payments or contributions may be nondeductible and income may be subject to the unrelated business income tax. We concede that these results may in fact occur. However, we also believe that these results generally are proper where the employer is assured of receiving in some form the benefit of the excess payments in a future year. In addition, as stated above, we are concerned that the approach of the proposed amendment may create a significant and inappropriate competitive advantage in favor of insurance companies vis-a-vis self-insured arrangements. If an adjustment is necessary in this area, it should be made on an across-the-board basis, and should not be made only for arrangements involving insurance companies.

Fourth, we understand that there is concern about the chilling effect the existing rule is having on the ability of the insurance companies to market and sell experience-rated products and arrangements to employers. Evidently, some claim that employers are reluctant to enter into experience-rated arrangements due to their fear that such arrangements will be treated as "funds."

We have not received any data in support of this claim. Thus, we are unable to determine whether the claim is supported by the facts. In addition, given the complexity of the issues, the variety of the products and arrangements offered by insurance companies, and the vagueness of the proposed amendment, we are not convinced that the amendment would succeed in eliminating the claimed chilling effect. Nevertheless, we would not oppose amending the third prong of the "fund" definition to provide that, with the exception of certain arrangements that are commonly considered to be "funds," an account held by any other person (such as the experience-rated arrangements with insurance companies that are within the proposed amendment) will not be treated as a "fund" before six months following the issuance of final regulations treating the account as a "fund." Such a delayed effective date, tied to final rather than proposed regulations, would be more effective than the proposed amendment at eliminating any current chilling effect involving employers' willingness to enter into nonrenewable, term arrangements with insurance companies.

Qualified employee discounts

Under section 132 of the Code, as added by the Tax Reform Act, a qualified employee discount is, within certain limits, excluded from an employee's gross income. An employee discount is the "amount by which the price at which the property or services are provided to the employee by the employer is less than the price at which such property or services are being offered by the employer to customers." To be qualified, an employee discount must be with respect to property (other than real property or personal property of a kind held for investment) or services that are offered for sale to customers in the ordinary course of the line of business of the employer in which the employee is performing services. If a discount does not fall within the definition of an employee discount, it cannot be a qualified employee discount and is includable in gross income (unless excludable under another statutory provision).

Section 153(a)(2) of the bill would amend the definition of qualified employee discount so that a discount would not be qualified unless the property or services provided by the employer are provided "to an employee for use by such employee."

We believe the proposed amendment is an appropriate technical correction, which conforms the requirements of a qualified employee discount to the requirements of the related provisions governing no-additional-cost services. A no-additional-cost service, which also is excludable from an employee's gross income, must be a service provided by an employer to an employee "for use by such employee."

In addition, the technical correction is consistent with the structure of section 132. In particular, section 132(f)(2) provides that, for purposes of the no-additional-cost service and qualified employee discount provisions, use by an employee's spouse or dependent child shall be treated as use by the employee. If it were not required that a qualified employee discount must be limited to property or services provided

for use by the employee, section 132(f)(2) would be meaningless as applied to qualified employee discounts.

The proposed amendment also is consistent with the statutory principle that only a certain class of employees are eligible for a qualified employee discount. If there were no requirement that the property or service be provided for the use of the employee, then an employee in the appropriate line of business of the employer could act as a conduit for anyone else, including, for example, an employee in a line of business not eligible for the qualified employee discount. In other words, the conduit employee could make the discounted purchase and immediately resell the property or the right to the service to another individual for the discounted price. Allowing the exclusion in such a situation would be inconsistent with the statutory limitations on the employees eligible for a qualified employee discount.

We note that in light of the statutory structure and underlying rationale of section 132, the same result could be reached by regulation without a technical correction. Nevertheless, we believe that this statutory clarification is appropriate.

We are, however, concerned with two aspects of the technical correction. First, we do not believe that the qualified employee discount exclusion should be denied where an employee gives property to a third party without any consideration. For example, if an employee working in a department store buys an item at a discount and gives it to his mother for Mothers' Day, the qualified employee discount exclusion should be available. Giving property or the right to a service to a third party as a gift should be considered use of the property or service by the donor. Again, although we believe we could reach this result without additional legislative guidance, we suggest that report language clarify this point.

Our other concern relates to the employer's withholding and employment tax obligations. If an employee is purchasing property as a conduit for a person who is ineligible for a qualified employee discount, the employee generally would be taxable on the discount. However, the employer may not know that the employee is reselling the property. In such cases, the employer does not have a withholding or employment tax obligation with respect to such taxable discount as long as at the time the discount was provided it was reasonable to believe that the employee would be able to exclude the discount from income. Employers must be able easily to determine under what circumstances it is reasonable to believe that the employee is not reselling the property and thus making the discount taxable. We believe that an employer should not be required to police use of the discounted property or services by employees as long as the employer has a bona fide policy, clearly communicated to employees, against resale by employees and the employer is not aware of facts that indicate this policy is not being observed. Again, appropriate committee report language would be helpful to confirm this point.

Interest exclusion for ESOP loans

The Tax Reform Act included a provision that permits banks, insurance companies and certain other lending corporations to exclude one-half of the interest earned on qualifying loans used by ESOPs or corporations to acquire employer securities. The exclusion applies to loans used to acquire employer securities on or after July 18, 1984.

Section 265(2) of the Code denies a taxpayer a deduction for interest on debt "incurred or continued to purchase or carry obligations the interest on which is wholly exempt from the taxes imposed by this subtitle." The Internal Revenue Service has made an administrative determination that a bank's liabilities to depositors are not incurred to purchase or carry tax-exempt obligations owned by the bank.

Section 291, however, disallows 20 percent of a bank's interest expense allocable to indebtedness "incurred or continued to purchase or carry obligations acquired after December 31, 1982, the interest on which is exempt from taxes." Section 154(c)(1) of the bill would amend section 291(e) to exclude interest exempt from tax under section 133 from the scope of section 291.

The Joint Committee Staff's General Explanation ("General Explanation") to the Tax Reform Act states that section 265 does not apply to interest on qualifying ESOP loans. This result is arguably correct for banks because interest exempt under the special ESOP provision included in the Tax Reform Act should be treated in the same manner as wholly tax-exempt interest on municipal bonds. The General Explanation, however, also states that section 291 does not apply to such loans, but notes that a technical correction would be necessary to exempt such interest from the provisions of section 291.

Reflecting the intention noted in the General Explanation, section 154(c) of the bill provides that interest on an obligation eligible for the exclusion available for ESOP loans will not be treated as tax-exempt interest for purposes of section 291.

We believe that the proposed amendment is inconsistent with the purpose of section 291 and the special ESOP provision and essentially treats interest income received by a bank that is exempt from tax under this provision more favorably than interest on municipal bonds. Interest received by banks that is exempt because the proceeds are used by a corporation or an ESOP to acquire employee securities should be treated in the same manner as interest on municipal bonds. Therefore, the Treasury Department opposes the proposed amendment to section 291(e).

Employer-operated eating facilities

The Tax Reform Act expressly provides that gross income includes fringe benefits except as otherwise provided in the Code. The Treasury Department is concerned with the administrability of this rule as applied to meals provided to employees in subsidized employer-operated cafeterias. Although no provision relating to this problem is currently included in the bill, we suggest that the Committee consider an additional technical correction to simplify its administration.

Section 132 excludes from income any de minimis fringe. Section 132 provides explicitly that the operation of an eating facility by an employer for its employees is treated as a de minimis fringe if the facility is located on or near the business premises of the employer and the revenue derived from the facility normally equals or exceeds the direct operating costs of the facility. This special cafeteria rule does not apply to officers, owners, or highly compensated employees, unless access to the facility is available on substantially the same terms to a nondiscriminatory class of employees.

If an employer-operated cafeteria fails either the direct operating cost test or the nondiscrimination test (and does not fall within the special section 119 exclusion for meals provided on the employer's premises for the employer's convenience), the value of the meals provided (net of any employee payments) will be taxable income to the employee. Accordingly, employers and employees will have to determine who received meals and how much those meals were worth.

We have explored the possible creation of administrative safe harbor valuations to eliminate the need for such detailed accounting, but have discovered significant problems concerning valuation of the total meals provided and allocation of the income (the excess of the total value over total revenues received) among the employees. For example, allocation of income pro rata among all employees would be unfair to employees who do not use the cafeteria frequently. On the other hand, although allocation of the income among all employees based on the number of times each used the cafeteria might be acceptable, many employers do not currently monitor who eats at the facility and the adoption of such a monitoring system would be burdensome and costly.

In light of these substantial administrative problems, we recommend consideration of a technical correction that would exclude from income any meals provided to an employee by his or her employer at an eating facility operated by the employer on or near the employer's premises, regardless of whether provided for the convenience of the employer. In conjunction with this amendment, we suggest an excise tax on the employer with respect to the subsidized portion of the meals. The excise tax rate would be set at a level that would approximate the taxes that would have been paid by the employees. Because the excise tax represents a proxy for the forgone employee taxes, consideration could be given to establishing one rate for facilities that do not discriminate in favor of officers, owners, or highly compensated employees and a higher rate for cafeterias that do not comply with the nondiscrimination provisions. The higher rate would be appropriate for cafeterias that fail the discrimination tests because officers, owners, and highly compensated employees are generally in higher income tax brackets than other employees. In our view, an excise tax regime would accomplish the intent underlying the fringe benefit provisions enacted in the Tax Reform Act, while avoiding significant administrative difficulties.

Interest paid to foreign persons

The Treasury Department proposes additional provisions for the portion of the bill relating to the 30 percent withholding tax on U.S. source interest paid to foreign persons. The Tax Reform Act generally repealed this tax with respect to interest on portfolio obligations issued after July 18, 1984.

The most significant proposal would clarify the scope of the repeal legislation; it would provide that only interest paid on an obligation issued pursuant to a public offering would qualify as "portfolio interest" eligible for repeal of the 30 percent tax. The legislation would be drafted to ensure that interest on debt that is in substance publicly offered and traded abroad would enjoy the exemption.

The Treasury Department believes that the purpose of the repeal legislation was to provide direct access to the Eurobond market for U.S. borrowers. When Congress in effect repealed the withholding tax for several years beginning in 1971, it limited the exemption to interest on underwritten public issues of debt obligations in the Eurobond market. The Treasury Department understands the intended scope of the repeal in the Tax Reform Act to have been similarly limited. This market consists of publicly offered obligations which trade in an active secondary market. It does not include trade indebtedness, the interest on which was for the most part exempt even prior to the Tax Reform Act, and privately placed obligations. The Treasury Department supported the repeal legislation because of the need to remove barriers to the public debt markets. The statutory language leaves the scope of repeal unclear, however.

The Treasury Department opposes unilateral repeal of the 30 percent tax on interest paid, for example, on trade indebtedness and obligations issued in private placements for two reasons. First, the policy basis for unilateral repeal with respect to publicly offered obligations does not apply to such obligations. Publicly offered obligations trade in an active secondary market. That is, the original holder of an obligation may sell it to another person who lives in another country, who in turn may sell it to a third person who lives in yet a third country. Any or all of these countries may have a tax treaty with the United States which eliminates the U.S. withholding tax. There is no way, however, for the issuer of the obligation to ensure that it will be held by only residents of treaty countries who will not be taxed on the interest. The only way to ensure that foreign persons will not be taxed on publicly offered obligations, and that these obligations will be able to trade freely in the Eurobond market, is to eliminate the tax by statute.

This rationale simply does not apply to obligations placed with a few private holders or trade indebtedness. If U.S. issuers of such obligations wish holders of their debt obligations to avoid the U.S. withholding tax, such issuers can feasibly target the obligations to residents of treaty countries. In this context, we believe it is inappropriate as a matter of tax policy to exempt income from tax unilaterally, in the absence of overriding policy reasons. This is particularly true in the current fiscal environment.

The second reason we oppose repeal of the 30% tax on interest paid on trade indebtedness and privately placed obligations is that other countries generally have not repealed their interest withholding taxes on such obligations. Exemption for such obligations should be negotiated through tax treaties, whereby reciprocal treatment can be obtained for U.S. sellers of goods and U.S. persons wishing to undertake private borrowings.

In addition to the foregoing proposal, Treasury would suggest some minor clarifications relating to the effective date of repeal and certifications required for registered obligations. We would be pleased to discuss these issues with Committee staff.

TECHNICAL CHANGES TO THE RETIREMENT EQUITY ACT OF 1984

In 1984, Congress enacted significant legislation altering the tax-qualification requirements and the corresponding labor provisions for employer-maintained profit-sharing, stock bonus, pension, and annuity plans to provide greater protection to plan participants, to surviving spouses of deceased participants, and to former spouses of plan participants. The Administration supported the Retirement Equity Act and continues to support the policies reflected therein.

H.R. 2110 contains various amendments to the Retirement Equity Act that are intended to clarify the original provisions where necessary and to resolve issues that were not fully addressed. These proposed amendments are important. We believe, however, that additional amendments to the Retirement Equity Act may be appropriate. Unfortunately, we have not completed our review of the Retirement Equity Act to identify additional technical amendments that should be made. We hope to complete this review in the near future and will report our conclusions at that time.

At the present time, however, we will discuss two of the proposed amendments to the Retirement Equity Act about which we currently have concerns.

Qualified domestic relations orders

Section 2(c)(4)(A)(v) of the bill provides that a plan will not fail to qualify solely because the plan makes a payment to an alternate payee (such as the former spouse of a plan participant or a child of the participant) under a qualified domestic relations order (QDRO), even though the payment is made with respect to a participant who has not separated from service. Under the bill, however, this rule would apply only if the present value of the benefit to be paid to the alternate payee does not exceed $3500. Thus, a plan would not be permitted to make payments to an alter

nate payee under a QDRO before the participant has separated from service, unless the present value of the benefits to be paid to the alternate payee is $3500 or less.

We oppose this proposed amendment. In our view, whether a qualified plan may make payments to an alternate payee under a QDRO before payments may otherwise be made to the participant should not be resolved on the basis of the present value of the payments. Rather, this issue should be resolved in terms of more basic policy concerns.

There appear to be at least two options for resolving this QDRO issue. Under each option, the value of the payments to be made to the alternate payee is immaterial. The first option would provide that until the participant separates from service for the employer, a qualified plan may not make payments to an alternate payee under a QDRO, even though the QDRO may direct that such payments be made and both the alternate payee and the plan agree to the payments. The second option would provide that a qualified plan may make a payment to an alternate payee under a QDRO before the participant separates from service if the QDRO directs that the payments be made and the plan itself authorizes such payment, even though the plan would not (or could not under the applicable qualification requirements) make such a payment to the participant because the participant has not separated from service.

We believe that the second option is far preferable to the first. The QDRO provisions were enacted primarily to provide plans with protection against disqualification and liability when they make payments in accordance with domestic relations orders where such orders do not conform with either the plan's provisions or the applicable qualification requirements. The second option is fully consistent with this original policy. Moreover, it allows essentially equivalent treatment of participants and alternate payees.

The first option goes beyond merely protecting plans and could result in unequal treatment of participants and alternate payees. This option essentially provides that no matter what the parties and the court determine to be the appropriate balancing of rights and obligations, payments to an alternate payee under a domestic relations order may not be made until the participant separates from service. Under current law, a pension plan may distribute benefits to a participant upon his or her separation from service. For an alternate payee, a divorce effectively severs his or her link to the employer maintaining the plan and thus may be seen as functionally equivalent to a participant's separation from service. Thus, we believe that the first option and the proposed amendment, which would preclude the distribution of benefits to an alternate payee under a QDRO even though the plan is willing to make and the alternate payee is willing to receive such distribution, are inconsistent with the policy of the original legislation.

In addition, it makes little sense to link the commencement of the alternate payee's payments under a QDRO to the participant's employment status. Presumably, after the domestic relations order, the lives of the participant and the alternate payee are separate, and the rules governing qualified plans should not prevent a court from treating a participant's and an alternate payee's benefits under a qualified plan separately.

Spousal consent and designated beneficiaries

Our second concern with the proposed amendments to the Retirement Equity Act relates to section 2(b)(6) of the bill which addresses the manner in which a spouse's consent to a participant's election not to receive a qualified joint and survivor annuity or a qualified preretirement survivor annuity (qualified survivor annuities) applies to the participant's selection of a nonspouse beneficiary to receive any remaining benefits upon the participant's death.

We object to that portion of the proposed amendment that provides that a spouse's consent to a participant's election not to receive a qualified survivor annuity may be limited so that the participant has the right to designate a nonspouse beneficiary of survivor benefits without further spousal consent.

The Retirement Equity Act was aimed at providing spouses of participants with protection under the participants' qualified plans by mandating that, in certain plans, a married participant would receive a qualified survivor annuity unless he or she elected, with spousal consent, not to receive such an annuity. We believe that, consistent with the original policy of the spousal consent requirement, a participant should not be permitted to alter, without further spousal consent, a beneficiary designation after the spouse has consented to the participant's election not to receive a qualified survivor participant's election not to receive a qualified survivor annuity. If the proposed amendment is enacted, we are concerned that the general form of spousal consent used by plans will include a waiver of the spouse's right to consent

to the designation of the participant's beneficiary and thus, in practical effect, will represent a significant weakening of the original spousal protections without any meaningful administrative advantage for plans.

The spousal protections granted by the Retirement Equity Act with respect to qualified survivor annuities are effective only if the protections apply to both the form of distribution of the participant's benefit (e.g., whether the benefit will be distributed in the form of a qualified joint and survivor annuity, a lump sum, or a term certain over a specified number of years) and to the designation of the beneficiary of any benefits remaining upon the participant's death. Eliminating the protections with respect to the latter would seriously erode the original policy of the provisions.

Many troubling situations may arise if the proposed amendment is enacted. For example, assume that the spouse consents to the participant's election not to receive a qualified survivor annuity and the participant promises to make the couple's child the beneficiary of any death benefits under the plan, but that, sometime later, the participant designates another individual, unrelated to the family, as the beneficiary of the plan's death benefits. If at the time of the original consent, the spouse waived the right to consent to subsequent designations of beneficiaries, which we believe is likely to become the usual practice, then the spouse's protection under the plan will have been lost. A spouse may be willing to give up a survivor benefit if the spouse's children are to receive the death benefits under the plan, but not if unrelated individuals may be the beneficiaries. Because the Retirement Equity Act did not require that spousal consent be revocable, it is important that the consent be specific as to each of the important aspects relating to survivor benefits under a plan.

Mr. JENKINS. Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Jenkins will inquire.

Mr. JENKINS. I have to go to a Budget Committee markup, but I have two questions that I want to go over with the staff and with the Treasury at some point in the near future.

My first concern is with item 23, section D. It appears to me that under this particular provision, that we are attempting to make death benefits and property rights taxable under section 79. I don't think that was the intent, and I will be talking with the staff about that.

Also, there is another provision under item 1(i) of the act on page 87. I will be talking to the staff to see if we can't clarify the meaning and intent of this because it appears to me that Treasury may have stepped beyond the legislative intent. It may not be that that has occurred, but I want to look into this.

Mr. MENTZ. I would be glad to work with the staff on that, Mr. Jenkins, if you like. Sure.

Mr. JENKINS. Thank you so much.

Chairman ROSTENKOWSKI. Are there any other questions of Mr. Mentz?

Mr. Rangel will inquire.

Mr. RANGEL. I want to first congratulate you on behalf of the delegation in New York for the fine contributions that you have made to the Congress, specifically, the Ways and Means Committee. You gave us the advice and experience of the lawyers of the great State of New York. I wish you well and look forward to working with you.

Mr. MENTZ. Thank you, Mr. Rangel.

Chairman ROSTENKOWSKI. Thank you very much, Mr. Secretary.

Mr. MENTZ. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. The committee will stand in recess. However, the next panel should take their places: Mr. Hiebert, Mr. Gaines, and Mr. Briggs.

The committee will resume its sitting in 15 minutes.

[Recess.]

Mr. GIBBONS [presiding]. The committee will come to order.

Let's have the next panel, please.

I want to make sure that we know what the ground rules are. This is a technical corrections bill and anybody that has anything in here that is changing the major substance of the law would do well to improve his or her credibility by admitting it. This is a technical corrections bill.

I am glad to see George Bean here. You are my constituent, the one I am interested in, and I appreciate you coming. You run the finest airport and airport system in the world. I know that because everybody tells me so.

Mr. BEAN. Thank you.

Mr. GIBBONS. Go ahead.

STATEMENT OF PETER N. HIEBERT, WASHINGTON COUNSEL, GOVERNMENT OF THE U.S. VIRGIN ISLANDS

Mr. HIEBERT. Mr. Chairman and distinguished members of the Committee on Ways and Means, my name is Peter N. Hiebert. I am an attorney with the law firm of Bishop, Liberman, Cook, Purcell & Reynolds, which serves as Washington counsel to the Government of the U.S. Virgin Islands.

I am pleased to have this opportunity to testify on behalf of the government in support of a technical amendment to the tax-exempt leasing provisions of the 1984 Tax Reform Act, which inadvertently eliminated an important incentive for capital investment in the Virgin Islands.

The tax exempt leasing provisions of the 1984 act generally deny the investment tax credit and accelerated cost recovery system [ACRS] deductions for property owned by a U.S. person and leased to or otherwise used by a tax exempt entity.

A tax exempt entity is generally defined under the 1984 act to include government agencies, domestic tax-exempt organizations and "any foreign person or entity."

This definition has the unintended effect of denying the benefits of bona fide leasing transactions to Virgin Islands corporations which are considered foreign to the United States.

The purpose of the 1984 tax-exempt leasing provisions, as reflected in the legislative history, is, in part, to prevent foreign governments and other foreign persons who are not subject to U.S. income tax from taking unfair advantage of U.S. tax laws.

Virgin Islands corporations, however, are subject to U.S. income tax, but Congress has expressly provided, under section 28(a) of the Revised Virgin Islands Organic Act, that Virgin Islands corporations satisfy their U.S. income tax obligations by paying their applicable tax to the Virgin Islands.

The 1984 tax leasing amendments thus nullify the leasing benefits expressly extended to Virgin Islands corporations by Congress as part of the Foreign Investors Tax Act of 1966 [Public Law 89-809].

According to the Senate Finance Committee report to the 1966 act, Congress acted to extend such benefits to the Virgin Islands

because it believed that "in view of the unique and close relationships that exist between the United States and its possessions, the economic development of these possessions should be stimulated by the same incentives that are offered to U.S. investment" [S. Rept. 89-1707].

The 1984 amendments may be viewed as treating foreign corporations more favorably than Virgin Islands corporations since an exception is made for foreign corporations if more than 50 percent of the gross income derived by the foreign corporation from the use of such leased property is subject to direct U.S. tax or included in the gross income of a U.S. shareholder under the subpart F rules.

On the other hand, a Virgin Islands corporation that pays full U.S. corporate rates would continue to be denied such benefits because Congress has determined elsewhere that the revenues raised by such taxes should go directly to the Virgin Islands Treasury.

The denial of such leasing benefits reduces the ability of the Virgin Islands to attract new capital investment and create new jobs. Correcting this technical oversight would have negligible revenue impact but would materially assist the Virgin Islands in its efforts to become economically self-sufficient.

Moreover, the proposed amendment, a copy of which is attached to the end of my statement, is fully consistent with Congress's intent to curb abuses involving the investment tax credit with ACRS provisions and, most importantly, is fully consistent with longstanding congressional policy to encourage capital investment in the Virgin Islands.

Thank you.

[An attachment to the prepared statement follows:]

TECHNICAL AMENDMENT TO H.R. 1800—THE TECHNICAL CORRECTIONS ACT OF 1985

IRC Section 168(j)(4)(C) is amended to read as follows:

"(C) FOREIGN PERSON OR ENTITY.—For purposes of this paragraph, the term 'foreign person or entity' means—

"(i) any foreign government, any international organization, or any agency or instrumentality of the foregoing, and

"(ii) any person who is not [(I)] a United States person [or (II) a corporation created or organized in, or under the laws of, a possession of the United States.]".

Mr. GIBBONS. All right. Who is next?

STATEMENT OF PAUL B. GAINES, CHAIRMAN, AIRPORT OPERATORS COUNCIL INTERNATIONAL, AND DIRECTOR OF AVIATION, CITY OF HOUSTON, ACCOMPANIED BY GEORGE BEAN, DIRECTOR OF AVIATION, HILLSBORUGH COUNTY AVIATION AUTHORITY. TAMPA, FL, CITY OF TAMPA, AND JAMES D. McCORMICK, DIRECTOR OF ECONOMIC AFFAIRS, AIRPORT OPERATORS COUNCIL INTERNATIONAL

Mr. GAINES. I am Paul Gaines, chairman of the Airport Operators Council International and director of aviation for the city of Houston.

Accompanying me this morning is Mr. George Bean, director of aviation for the Tampa (Florida) International Airport, and also Mr. Jim McCormick, director of economic affairs for AOCI.

AOCI is the association of the governmental bodies which own and operate the principal airports served by the scheduled airlines

in the United States as well as in many other countries of the world. AOCI's U.S. member airports annually enplane more than 90 percent of the domestic and virtually all of the U.S. international scheduled airline passenger and cargo traffic.

We have submitted a written statement for the record, and I will highlight the primary area of concern to airport operators, and I believe they are consistent with your instructions.

The Technical Corrections Act of 1985 corrects one weakness in the Deficit Reduction Act of 1984 which allowed the IRS to impose ill-advised temporary regulations creating a major problem for airports.

We appreciate that section 164(c) of the Technical Corrections Act clarifies the intent of Congress in allowing an exception to the term private activity bond for airport bond so long as the facility is owned by or on behalf of a governmental unit.

Mr. GIBBONS. Would that be on the airport property? Must that be on airport property?

It could be anywhere; it could be an office building downtown?

Mr. GAINES. On the airport property, part of the airport. That has been our interpretation of the meaning of the Deficit Reduction Act since it was enacted.

In our testimony before the Department of Treasury, AOCI asserted, consistent with the legislation before you, that the regulations did not comport with the intent of the law.

The Technical Corrections Act confirms our belief and corrects the problem by providing specific language to that effect. On behalf of our U.S. airport members, AOCI thanks the committee for that needed clarification, and urges its retention in the final bill.

Mr. GIBBONS. I am anxious to help airports and air traffic, but I am not anxious to help airports create tax shelters for people that are really not directly related to the airport.

Is there enough in this technical correction to make sure that we are relating these to airport activities, airport operations, not, say, a law office or some unrelated type of business?

Mr. GAINES. I think in my understanding of it, that is correct.

Mr. GIBBONS. I could accept it as a technical correction if limited to the airport, airport-type operations, ones directly supportive of air travel, but if it wanders away from that, I am going to have to oppose it.

I want staff to take a quick look at it and make sure that this amendment is tight enough so that we are not creating any additional problems for us.

I don't want airports to become a haven for people seeking tax exempt financing. I want airports to be a place that promotes air travel and promotes safety in air travel.

Mr. GAINES. I think that is certainly the intent. However, several other provisions of the Deficit Reduction Act remain sufficiently unclear as to cause additional difficulties for public airport bond issues to qualify for the exception to the term private activity bond or to be tax exempt.

The immediate crisis for U.S. public airports is that so long as these questions as to the intent of Congress remain, bond counsels can not give and issue an unqualified opinion that a particular

issue qualifies for the exemption. This has the net effect of disqualifying that issue for the tax exemption.

We therefore urge that the law be amended or that the committee report on the Technical Corrections Act make clear that, one, in order for an airport bond issue to qualify for the exception to the term private activity bond, the section 103 requirement for Government ownership of the financed facility be clarified to distinguish it from other ownership tests within the code.

Two, that reductions for rental payments that do not violate the prohibition against front-end loading not be affected by the lessee election under 103(n)(7)(C)(iii).

Three, where an airport lessee or sublessee, without the permission of the airport lessor, violates its election by taking depreciation or an investment credit, the IRS shall deny the deductions and not retroactively disqualify the tax-exempt, non-private activity nature of the outstanding airport bond issue.

Four, consumer or private loan bonds shall not include obligations used to finance facilities for which a lessor collects rental payments under a lease to retire the bond issue.

Our concerns are detailed in the written submittal.

Mr. Chairman and members of the committee, AOCI appreciates this opportunity to express our concerns. We hope that you will agree that further clarification is needed in the Technical Corrections Act.

[The prepared statement follows:]

STATEMENT OF PAUL B. GAINES, CHAIRMAN, AIRPORT OPERATORS COUNCIL INTERNATIONAL

Mr. Chairman and members of the committee, I am Paul B. Gaines, Chairman of the Airport Operators Council International and Director of Aviation for the City of Houston, Texas. Accompanying me is Mr. James D. McCormick, Director of Economic Affairs for AOCI.

The Airport Operators Council International is the association of the governmental bodies which own and operate the principal airports served by the scheduled airlines in the United States as well as in many other countries. AOCI's U.S. member airports annually enplane more than 90% of the domestic and virtually all of the U.S. international scheduled airline passenger and cargo traffic.

SUMMARY OF OUR TESTIMONY

The Technical Corrections Act of 1985 (H.R. 1800) corrects one weakness in the Deficit Reduction Act of 1984 which allowed the IRS to impose ill-advised temporary regulations creating a major problem for airports. However, several other provisions of the Deficit Reduction Act remain sufficiently unclear as to cause additional difficulties for public airport bond issues to qualify for the exception to the term "private activity bond" or to be tax-exempt. The immediate crisis for U.S. public airports is that so long as these questions as to the intent of Congress remain, bond counsel can not give an issuer an unqualified opinion that a particular issue qualifies for the exception. This has the net effect of disqualifying that issue for the exception or for tax exemption.

We, therefore, urge that either the law be amended or that the Committee Report on the Technical Corrections Act make clear that:

1. in order for an airport bond issue to qualify for the exception to the term "private activity bond", the Section 103 requirement for government ownership of the financed facility be clarified to distinguish it from other ownership tests within the Code;

2. deductions for reasonable rental payments that do not violate the prohibition against front-end loading will not be affected by the lessee election under 103(n)(7)(C)(iii);

3. where an airport lessee or sublessee, without the permission of the airport lessor, violates its election by taking depreciation or an investment credit, the IRS

shall deny the deductions and not retroactively disqualify the tax-exempt, non-private activity nature of the outstanding airport bond issue;

4. consumer or private loan bonds shall not include obligations used to finance facilities for which a lessor collects rental payments under a lease to retire the bond issue.

Our concerns are detailed below.

"ENTIRE FACILITY" RULE

We appreciate that Section 164(c) of the Technical Corrections Act clarifies the intent of Congress in allowing an exception to the term "private activity bond" for airport bonds so long as the facility being financed is owned by or on behalf of a governmental unit and the lessee makes an irrevocable election not to claim depreciation or an investment credit on the facility financed. That has been our interpretation of the meaning of the Deficit Reduction Act since it was enacted. In our testimony before the Department of the Treasury, AOCI asserted, consistent with the legislation before you, that the regulations did not comport with the intent of the law. The Technical Corrections Act confirms our belief and corrects the problem by providing specific language to that effect. On behalf of our U.S. airport members, AOCI thanks this Committee for that needed clarification.

However, several problem areas remain.

QUESTIONS REGARDING GOVERNMENT OWNERSHIP TEST

We believe the Technical Corrections Act or the Committee Report should clarify that the government ownership requirement of Section 103 is complete as written and should not be confused with ownership guidelines contained in other parts of the Code. For example, questions as to the applicability of ownership guidelines such as those concerning leveraged leases raise legal concerns and, in some circumstances, may taint an otherwise qualifying airport bond issue.

EFFECT OF LESSEE ELECTION

Under section 103(n)(7)(C)(i) of the current law, an airport bond issue qualifies for the exception only if the property financed "is owned by or on behalf of a governmental unit." Section 103(n)(7)(C)(iii) describes the circumstances under which property is considered to be owned by a governmental unit: "For purposes of clause (i), property shall not be treated as not owned by a governmental unit solely by reason of the length of the lease to which it is subject if the lessee makes an irrevocable election (binding on the lessee and all successors in interest under the lease) not to claim depreciation or an investment credit."

Section 1.103(n)-2T, A-6 of the regulations, however, contains the following sentence regarding the lessee election under that clause:

If the property, or any portion thereof, is leased to a nongovernmental entity and if, for Federal income tax purposes generally, the lessee is the owner of the property solely by reason of the length of the lease, then, for purposes of subsections 1.103(n)-1T through 1.103(n)-6T *(but not for other Federal income tax purposes, such as whether payments under the lease constitute deductible rental payments),* the governmental unit will be treated as the owner of the property if the lessee elects not to claim depreciation or an investment credit with respect to such property. (Emphasis added.)

The parenthetical passage from the regulations quoted above suggests that a lessee who elects not to take depreciation or an investment credit may not be entitled to deduct his rental payments under the lease. We believe it was not the intent of Congress that an electing lessee should forego any deduction for its payments under the lease, and the most logical deduction would be rent. In fact, the rules against "front-end loading" of lease payments under section 103(n)(7)(C)(iv) would appear to anticipate deductions for rent, and is intended to disallow a lessee from achieving any greater tax advantage by virtue of its rental payment deductions than straight-line depreciation would allow. The significant point, however, is that Congress did not intend to disallow the deduction of rental payments.

To carry this argument to its logical conclusion, denial of deductions for rental payments would be such an extreme penalty that no lessee would make the election. Accordingly, the interpretation above would result in an effective repeal of the provisions of section 103(n)(7)(C) of the Code.

We request that the final version of the Technical Corrections Act include additional language to clarify that, in order for an issue described in section 103(b)(4)(C) or (D) to qualify for the exception to the term "private activity bond," a lessee's

election not to claim depreciation or an investment credit will satisfy the requirement to prove ownership by a governmental unit notwithstanding the length of the lease, but that the election under Section 103(n)(7) will not involve an election not to claim Federal income tax deductions for other payments under the lease that may be allowed by other sections of the Code.

ENFORCEMENT OF THE LESSEE ELECTION

As you know, for the airport exception to the term "private activity bond" to apply, the lessee must make an irrevocable election, binding on all successors under the lease, not to take depreciation or an investment credit. Section 1.103(n)-2T of the temporary regulations provides that "If a successor in interest claims depreciation or an investment credit with respect to property for which an election has been made, such property will be considered transferred to a non-governmental entity" and that the bonds outstanding on the date on which government ownership ceases are deemed to be private activity bonds. The outstanding bonds are thus treated as if they are the last private activity bonds issued by the issuer in the calendar year in which the transfer of ownership (or claim of depreciation) occurs. If all of the state cap has been allocated to other issues, the bonds in question would not be tax-exempt.

In addition, the regulations specify that the lessee is not entitled to claim depreciation or an investment credit and will be subject to the applicable penalties for so claiming depreciation.

To eliminate this "double jeopardy," we suggest that the Technical Corrections Act specify that an obligation that is not a private activity bond shall continue not to be a private activity bond even if a lessee violates his irrevocable election, and that the IRS only shall deny the depreciation or investment credit deduction.

EFFECT OF DENIAL OF TAX EXEMPTION FOR "CONSUMER LOAN BONDS"

Section 626 of the Deficit Reduction Act denies tax exemption to "consumer loan bonds," which are described as obligations which are not IDBs, but ". . . . all or a significant portion of . . . which are reasonably expected to be used . . . to make or finance loans . . . to persons who are not exempt persons . . ." It is our understanding that, generally, the term "significant portion" is considered to mean 5% or more.

Although the Technical Corrections Act would change the term "consumer loan bonds" to "private loan bonds," we believe an unintended problem possibly has been created for smaller air carrier-served airports which would not be corrected by the change of terms.

Whereas a "major portion" of an airport bond issue (generally considered to mean 25% or more) must be used in the trade or business of non-exempt persons in order for the bond issue to be treated as an IDB, facilities at smaller airports may be used less than 25% in the trade or business of non-exempt persons. Bond issues used to finance such facilities, therefore, would not be treated as IDBs.

However, if such smaller airport facilities were to be used more than 5% by non-exempt persons, the bonds may be considered as "consumer" or "private loan bonds" and thus would lose their tax exemption altogether. We believe that the term "loan" should not extend to leases of publicly-owned facilities. Currently, the effect of the statute is unclear on this matter.

We request that the final version of the Technical Corrections Act address this problem so that smaller airport bonds will continue to be tax-exempt.

Mr. Chairman and members of the Committee, AOCI appreciates this opportunity to articulate our concerns, and we hope that you will agree that further clarification is needed in the Technical Corrections Act. Thank you.

Mr. GIBBONS. What is an airport? Is it a heliport?

Mr. GAINES. It can be, but an airport is an interface.

Mr. GIBBONS. Give me that again?

Mr. GAINES. An airport is an interface between modes of transportation.

Mr. GIBBONS. I am going to ask you some ridiculous questions now.

If I owned a little piece of land and decided I wanted to issue tax-exempt obligations and I established a small short takeoff and

landing airfield that only a helicopter could get into, could I take advantage of the tax-exempt provisions?

Is that an airport that qualifies for tax-exempt obligations?

Mr. MCCORMICK. Is the aircraft being used in business or is it a privately owned aircraft being used for pleasure?

Mr. GIBBONS. Who knows. You have to land and you want to get a tax-exempt obligation. You could have one commercial flight in there a month, take your mother-in-law on a flight.

Mr. MCCORMICK. The requirement is that it has to be a publicly owned airport and all the airport facilities—under definition of the Tax Code—to qualify for tax exemption must be publicly owned.

Mr. GIBBONS. Must it be contiguous to the airport or can it be detached from the airport?

Mr. GAINES. We believe it has to be part and parcel of the airport.

Mr. GIBBONS. That is contiguous, immediately adjacent to, not across the street from.

Don't nod. The nod doesn't go in the record. Tell me yes or no.

Mr. GAINES. That is my understanding.

Mr. GIBBONS. Any other questions of this panel of witnesses—we have one more, haven't we?

STATEMENT OF THOMAS P. BRIGGS, MANAGER OF REVENUE, CITY AND COUNTY OF DENVER, CO

Mr. BRIGGS. Yes, sir.

Mr. Chairman and members of the committee, my name is Tom Briggs. I am manager of revenue for the city and county of Denver. I would like to request that my written statement be——

Mr. GIBBONS. All statements will be included in the record.

Mr. BRIGGS. I would also like to associate our airport with the remarks of Paul Gaines and his organization.

I would also like to briefly summarize the main points I would like to present.

As part of my responsibilities, I handle the financing of our public airport. Our airport is owned by the city and county of Denver and operates as a unit of our public works department. This arrangement is typical of many major airports such as Houston, Dallas-Fort Worth, Chicago, and San Francisco.

I want to thank the committee for its support over the last few years. We appreciate the recognition you gave to the financing problems of publicly owned airports last year. Your decision to exempt publicly owned airports from the IDB volume cap was, I believe, a statement that while airport expansions are large and costly projects, they are only undertaken when a serious public need is demonstrated.

We believe it is the responsibility of local governments to provide for the air facilities to transport our people and to facilitate commerce by moving goods and services in and out of the geographic areas we serve. To accomplish this, we enter into agreements with the private sector to facilitate these functions in an economically efficient manner.

Upon their completion, these agreements, use agreements and contracts with concessionaires, are used to form the basis of financ-

ing transactions entered into by the public airport to create the physical facilities at the airport. I use the word concession, use, and lease agreement very carefully. The reason is that the public airport seeks to retain as much control over the facility and over the private sector users as possible to ensure that our public purpose objectives are met to the fullest extent possible.

These agreements entered into for public service purposes may be precluded from the use of tax-exempt financing under the rules of the act of 1984. The provisions contained in H.R. 1800 go a long way toward fixing these problems. However, there are regulations issued by the Treasury regarding tax ownership, a new concept, that are simply too broad to be put to practical use in our airport management activities.

We support the committee's provision addressing this issue and encourage its adoption, but suggest that additional problems remain that may need to be addressed.

There are a few other technical problems with the 103(b) rules regarding airports that I would like to quickly bring to your attention. If it is not appropriate to address them in this bill, we would be pleased to work with the committee staff——

Mr. GIBBONS. If they are not technical corrections, let's forget about them.

Mr. BRIGGS. I believe they are technical. However, if the staff or you do not believe that they are, we would like the opportunity to come back later and address them in the future.

Mr. GIBBONS. Try them out on our staff, would you, please?

Mr. BRIGGS. There is no clear ruling as to the restrictions on land acquisition, a factor that could conceivably increase costs to both Denver as we build our new airport and to the Federal Government as it supports that building through the AIP Program.

It may be necessary to purchase land in small increments throughout the construction phase of the program. This conceivably will increase our cost of construction of the new airport and may actually affect design and safety factors of the airport since we cannot plan to build facilities on land that we do not control.

We believe that this rule as well as others classifying public airports—and to classifying public airports as industrial development bonds creates a costly and unnecessary burden on these public facilities, particularly for the larger airports I mentioned, these costs will be significant over the next few years.

Clearly we face additional problems in the context of overall tax reform as well. We feel that, as with roads and bridges, our airports are a transportation mode serving a public purpose and owned by a public entity and should therefore be considered long term more like traditional municipal bonds than as IDB's.

Thank you for your consideration of my concerns this morning and more importantly for the excellent work that the committee has done in the past on behalf of our public airports.

Mr. GIBBONS. Thank you.

Do the members have questions for this panel? Thank you very much.

[The prepared statement follows:]

STATEMENT OF THOMAS P. BRIGGS, MANAGER OF REVENUE, CITY AND COUNTY OF DENVER, CO

My name is Tom Briggs. I am Manager of Revenue for the City and County of Denver. As part of my responsibilities, I handle the financing of our public airport. Our airport is owned by the City and County of Denver and operates as a unit of our Public Works Department, just like the roads and bridges and the wastewater management systems. While this is one typical form of organization for a public airport, others are instrumentalities of one or more governments.

The purpose of a public airport is to provide transportation services to citizens of a particular geographic area. We do this to facilitate commerce and to provide for the convenience of our citizens for all their traveling needs. In this sense, a public airport is no different from a road or a bridge.

One important outcome of this activity is to broaden the economic base of a particular geographic area by making it a transportation center. Cities compete with one another for status as a transportation center, be it railroad, highway, seaway, or airport, because of the critical economic impact of being a hub of the movement of goods and people. Denver, for example, would not be the City it is today without its airport. Had another city, such as Cheyenne, Wyoming or Albuquerque, New Mexico, built its airport as we did in 1930s and 1940s, complementing existing road and rail facilities, one of them would occupy the financial, commercial and administrative role for the Rocky Mountain region that Denver now enjoys.

The means of achieving the objectives of facilitation of commerce and providing for the convenience of the people is to enter into a unique public/private partnership for the development of the airport. Airlines are granted rights to use certain airfield and groundside facilities for fees which are typically governed by use agreements of far shorter duration than the economic life of the facilities. These use agreements vest control in the public airport and severely limit activities by private entities. Other essential activities are handled by the public airport directly or through concessions. One example is the sale of goods at the airport. Most local governments are loath to enter into competition with the private sector and therefore lease space to concessionaires to handle this function. The leases contain performance requirements conforming to the public airport's perception of the needs of the people.

I would like to point out that I have used the words concession, lease, and use agreement, carefully. The reason is because public airports universally seek to retain as much control over the facility as possible to ensure that its original objectives are achieved. Those objectives were to facilitate commerce and to provide for the convenience of the traveling public so that the growth potential of the underlying economic base can be maximized, are best served by these types of arrangements which maximize public control of the facilities and their use.

Once the airlines agreement, concession agreements, and other elements of the partnership are in place, financing transactions are entered into by the public airport to create the physical facilities at the airport.

In recent years, airport financings have been severely restricted due to classification as industrial development bonds. General airport revenue bonds are very different from the typical industrial development bond that finance a single-lessee facility over its useful life. Airports are characterized by multiple users, short-term agreements, control vested in the public entity, service to governmental needs, and open physical access to the general public.

The Technical Corrections bill, while addressing some of the most egregious problems occasioned by the classification of General Airport Revenue Bonds as IDBs, does not solve the larger issues of the potential for loss of tax-exemption, significantly increased costs, and restrictions on planning and construction due to inability to complete financings in an orderly fashion. Thus, while we in Denver urge a favorable report of the Technical Corrections Bill from this Committee, and express our appreciation for the efforts of those behind the bill, we wish to note that the larger issues should also be addressed. Indeed, we feel they must be addressed if Denver has a hope of success in its efforts to provide for the needs of the people in our region for air transportation.

There are five principal issues that should be addressed. First, our ability to enter the tax-exempt market is directly threatened since IDBs are likely to be eliminated in whatever legislation arises out of the Administration's tax simplification program. Second, even if tax-exemption were retained, classification as IDBs will force Denver to issue tens of millions of dollars in additional bonds because the current IDB restrictions result in a less cost-effective method of project development for public airports. This will burden us as we attempt to build a new airport and will

actually create an additional shelter from income tax at a cost of millions of Federal tax dollars to the Federal Treasury due to the increased bond financing necessitated by the classification of airport bonds as IDBs.

Third, we are prohibited from prudent debt management practices such as advance refundings. This means we are subject to the whim of the market on the day we initially finance with no opportunity to improve our costs by refunding until we are past the call date, itself a market-determined aspect of the financing. Investors will want the longest call date possible when rates are high, effectively forcing a high interest rate burden onto the airport for the longest possible period.

Fourth, there is no clear ruling as to the restrictions on land acquisition, a factor that conceivably could increase our costs substantially as we would be required to acquire land in very small increments throughout the construction phase of the program. This will likely affect design and feasibility of the airport, since we could not reasonably include land in our construction plan that we did not control at the outset of design.

Finally, the tax ownership issue is very significant. IDBs are subject to Treasury definitions and rulings in this area, which could conceivably cause even general obligation debt to lose its tax-exempt status if tax ownership problems were encountered. This is a new area, one in which no one has significant experience and one which contains real pitfalls.

Thank you again for the recognition of the public airport as a unique entity in our federal structure and, specifically, for the corrections contained in the bill now before you. I look forward to further work with you and others as we move to address the remaining issues I see as so vital to the success of Denver as our City moves to serve the people of the Rocky Mountain region by building an adequate link in our nation's air transportation system.

Mr. GIBBONS. The next panel consists of Mac Asbill, Mr. Heymann, and Mr. Tavss.

STATEMENT OF MAC ASBILL, JR., SUTHERLAND, ASBILL & BRENNAN, ON BEHALF OF THE HOWARD ROSE CO.

Mr. ASBILL. Mr. Chairman, I appear today as counsel for a small privately held California company by the name of Howard Rose Co., which has an October 31 taxable year. In September 1984, in the company's 1984 fiscal year, Howard Rose redeemed a portion of its stock pursuant to section 303. In December 1984, the company was liquidated pursuant to section 333.

In the Deficit Reduction Act of 1984, there were amendments made with respect to the computation of earnings and profits and how they would be affected by redemptions, such as the 303 redemption Howard Rose went through, that are treated as sales or exchanges of stock.

Under prior law, such a redemption by a corporation of its stock would reduce earnings and profits by an amount equal to the excess of the amount of the distribution over the amount properly chargeable to the corporation's capital account. However, under section 312(n)(8), added by the DEFRA, earnings and profits would be reduced by the same fraction of the distribution as the amount of stock that is redeemed bears to the total stock outstanding before the redemption. The general effect of that was to reduce the adjustment to earnings and profits caused by a 303 redemption.

Now Congress inadvertantly failed specifically to provide an effective date for the provision I am talking about, 312(n)(8), but the legislative history, I think, shows clearly that they intended that date to be effective with respect to redemptions in taxable years beginning after September 30, 1984. That would be in the case of Howard Rose, its 1985 fiscal year.

However, the Technical Corrections Act in section 104(e)(3) provides, and I think clearly erroneously, that section 312(n)(8) is to apply to redemptions after July 18, 1984, in taxable years ending after that date. That would make the change apply to the Howard Rose's redemption, whereas I think that the intention of Congress was not to have it apply.

The shareholders of this little corporation, I think, clearly reasonably believed that 312(n)(8), the change in the law made by DEFRA, would be effective no earlier than with respect to redemptions occurring in taxable years beginning after July 18, 1984, which was the date of enactment of DEFRA. That would have been the result under the Senate bill that finally became DEFRA.

Prentice-Hall, which is, as you know, a respected tax service, recognized that the conference report on DEFRA omitted the effective date for 312(n)(8) and Prentice-Hall indicated that that omission was going to be corrected in the Technical Corrections Act and that the effective date would be the taxable years beginning after September 30, 1985.

Mr. GIBBONS. Is it in the technical corrections bill at this time?

Mr. ASBILL. The technical corrections bill filled the void in DEFRA which did not have an effective date. The technical corrections bill put the wrong effective date in there and in doing so, I think, made a substantive change instead of a technical correction and I would like that corrected.

Mr. GIBBONS. I understand.

Mr. ASBILL. Specifically, just to show you how that would impact this little company, the adoption of the proposed effective date would increase the amount of earnings and profits treated as a dividend resulting from their liquidation from approximately $220,000 to $388,000, an increase of over 75 percent, and I don't think that could have been anticipated.

I think for the reasons stated in our statement, Mr. Chairman, that it is clear that the omission of an effective date in the conference report was an error. I think it is also clear that the conference report intended to adopt the same rules as the Senate version of the bill had done which would have made a later effective date. I think it would be entirely appropriate for the Technical Corrections Act to correct that error and provide for a later effective date.

Mr. GIBBONS. Your problem is you think there was an error in the effective date and you think they put in the wrong effective date?

Mr. ASBILL. That is exactly correct.

Mr. GIBBONS. Do you know anybody else that is caught in the same predicament?

Mr. ASBILL. I am not sure of that. I have heard—I have not had a chance to investigate yet, Mr. Chairman—I understand there is at least one other person who is caught in the same bind and I intend to follow up on that. That is somebody, I think, in Colorado.

Mr. GIBBONS. We thank you very much.

Are there further questions of Mr. Asbill?

[The prepared statement follows:]

STATEMENT OF MAC ASBILL, JR., SUTHERLAND, ASBILL & BRENNAN, ON BEHALF OF HOWARD ROSE CO.

SUMMARY OF TESTIMONY

1. Section 61(a) of the Deficit Reduction Act of 1984, adding new section 312(n)(8) to the Internal Revenue Code, establishes the manner in which corporate earnings and profits are to be reduced upon a distribution in redemption of stock. Specifically, earnings and profits are to be reduced by the same fraction of the distribution as the amount of stock that is redeemed bears to the total stock outstanding before the redemption. Under prior law, earnings and profits were reduced by an amount equal to the excess of the amount of the distribution over the amount properly chargeable to the corporation's capital account.

2. Section 312(n)(8) was originally proposed as one of a series of provisions contained in section 47 of S. 2062 relating to earnings and profits. Six of these provisions, including the provision relating to redemptions, were to be effective in "taxable years beginning after the date of the enactment. . . ."

3. The Conference Committee Report accompanying the Deficit Reduction Act of 1984 delayed the effective date of five of the six provisions described above to "taxable years beginning after September 30, 1984." No specific effective date was provided for the remaining provision, section 312(n)(8), relating to redemptions.

4. However, the Conference Report indicates that the "conference agreement generally follows the Senate amendment with several modifications" and reiterates that statement specifically with reference to section 312(n)(8). There is absolutely no indication that Congress intended section 312(n)(8) to have an effective date different from that of the other five provisions contained in the Senate Bill that had the same effective date.

5. Section 104(e)(3) of H.R. 1800, the Technical Corrections Act of 1985, provides that section 312(n)(8) (renumbered as section 312(n)(7) by the Technical Corrections Act) applies to distributions after July 18, 1984, in taxable years ending after such date.

6. Adoption of the proposed effective date would appear to be directly inconsistent with Congressional intent in enacting section 312(n)(8) and thus would seem to be a very substantive change that violates the Chairman's admonition that only technical corrections, and not substantive changes, be considered for purposes of the Technical Corrections Act of 1985.

7. I respectfully urge the Committee on Ways and Means to conform Section 104(e)(3) of H.R. 1800 to the intended effective date of section 312(n)(8) by specifically providing that section 312(n)(8) (or section 312(n)(7) if section 312(n)(8) is so renumbered by the Technical Corrections Act) is effective with respect to redemptions in taxable years beginning after September 30, 1984.

STATEMENT

I appear today as counsel for Howard Rose Company ("HRC"), a small, privately held California corporation which has an October 31 taxable year. In September, 1984, its 1984 fiscal year, HRC redeemed a portion of its stock pursuant to section 303 of the Internal Revenue Code of 1954, as amended (the "Code"). In December, 1984, HRC was liquidated pursuant to section 333 of the Code.

Section 312(n)(8) of the Code, which was added by the Deficit Reduction Act of 1984, changed the manner in which earnings and profits are to be reduced upon a redemption by a corporation of its stock in a transaction, such as one under section 303, that is treated as a sale or exchange of the stock. Under prior law, upon such a redemption by a corporation of its stock, earnings and profits were reduced by an amount equal to the excess of the amount of the distribution over the amount properly chargeable to the corporation's capital account. Under section 312(n)(8), earnings and profits are to be reduced by the same fraction of the distribution as the amount of stock that is redeemed bears to the total stock outstanding before the redemption.

Although Congress inadvertently failed to specifically provide an effective date for section 312(n)(8), the legislative history of this provision confirms that Congress intended section 312(n)(8) to be effective with respect to redemptions in taxable years beginning after September 30, 1984, i.e., in HRC's case, its 1985 fiscal year. However, section 104(e)(3) of H.R. 1800, the Technical Corrections Act of 1985, provides, I believe erroneously, that section 312(n)(8) (renumbered as section 312(n)(7) by the Act), is effective for redemptions after July 18, 1984, in taxable years ending after such date.

The shareholders of HRC reasonably believed that section 312(n)(8) would be effective no earlier than with respect to redemptions occurring in taxable years beginning after July 18, 1984, the date of enactment of the Deficit Reduction Act of 1984 (HRC's 1985 fiscal year). That would have been the result under the Senate bill. Moreover, the Prentice-Hall Federal income tax service recognized that the Conference Report had omitted the effective date for section 312(n)(8) and indicated that the omission would be corrected in a technical corrections act providing for a September 30, 1984 effective date. 33 Prentice-Hall Federal Taxes Report Bulletin ¶60,359 (July 24, 1984).

Adoption of the proposed effective date would make the new provision applicable to the transactions described above that occurred in HRC's 1984 fiscal year, thereby resulting in an additional tax liability to such shareholders of approximately $80,000. Specifically, adoption of the proposed effective date would increase the amount of earnings and profits treated as a dividend upon the section 333 liquidation from approximately $220,000 to $388,000, an increase of over 75 percent.

Responding to concerns that corporate earnings and profits did not accurately reflect economic income, thus providing unintended tax benefits to shareholders when distributions were made, the Senate Finance Committee proposed several changes to section 312 of the Internal Revenue Code of 1954, as amended. S. 2062, Section 47(d). Six of these provisions, including the provision here involved relating to the effect of redemptions upon corporate earnings and profits, were to be effective with respect to "amounts paid or incurred in, or distributions or redemptions occurring in, taxable years beginning after the date of enactment. . . ." S. 2062, Section 47(d)(1)(A).

The Conference Committee Report indicates that the "conference agreement generally follows the Senate amendment with several modifications." Of the six provisions of the Senate bill providing an effective date with respect to "amounts paid or incurred in, or distributions or redemptions occurring in, taxable years after the date of enactment," five of the provisions were made applicable by the conferees to taxable years beginning after September 30, 1984. The effective date for the sixth provision, section 312(n)(8) relating to redemptions, was inadvertently omitted.

Moreover, with respect to the other four provisions contained in section 47 of S. 2062, the Conference Report extended three of the effective dates to September 30, 1984. (sections 312(n)(4), 312(n)(6), and 312(n)(7)), and left the fourth unchanged (section 312(a)(2), 312(o)). In other words, in no instance in which a specific effective date was enacted did the Conference Report adopt an effective date earlier than that proposed by the Senate bill, and in all but one case, extended the effective date to September 30, 1984.

When it addressed section 312(n)(8), the specific provision here involved, the Conference Report stated that the "conference agreement is generally the *same as* the Senate amendment," but failed to specify the effective date of such provision. [Emphasis added.] There is absolutely no justification for inferring that this omission was intentional or that it reflected a conscious decision by the conferees to make the effective date of section 312(n)(8) different from the effective date proposed by the Senate bill, except for the delay in the effective date to September 30, 1984 that was adopted by the Conference Report with respect to eight of the other nine provisions of the Senate bill. Indeed, where the conferees intended one of the provisions of section 61 of the Deficit Reduction Act relating to earnings and profits to be effective as of the date of enactment, they specifically so provided. Section 61(e)(4) of the Act; Section 301(f) of the Code. It would be erroneous to assume that the conferees intended to achieve the same result with respect to section 312(n)(8), a different subsection of the same section of the Act, by omitting an effective date for that provision. Accordingly, the only reasonable inference that can be drawn from the legislative history, including the Conference Committee's action, is that Congress inadvertently failed to provide that the provisions of section 312(n)(8) would be effective with respect to redemptions in taxable years beginning after September 30, 1984.

Section 104(e)(3) of H.R. 1800, the Technical Corrections Act of 1985, provides that the effective date of section 312(n)(8) (renumbered as section 312(n)(7) by the Act) is July 18, 1984. Adoption of this proposed effective date can be justified only by the conclusion that by failing to specifically provide an effective date for section 312(n)(8), Congress intended the effective date to be the date of enactment. As noted above, this conclusion would be totally unsupported by the legislative history of section 312(n)(8). Thus, section 104(e)(3), in effect, provides a substantive legislative change and does not constitute a technical amendment.

I believe that a technical amendment to section 312(n)(8) is entirely appropriate in light of the failure to specifically provide an effective date for that provision. Section 104(e)(3) of the Technical Corrections Act of 1985 is not such an amendment, however. I respectfully urge the Committee to adopt a technical amendment that

confirms Congressional intent, as clearly expressed in the legislative history of section 312(n)(8), that the provision be effective with respect to redemptions in taxable years beginning after September 30, 1984.

Mr. GIBBONS. Mr. Heymann, let's go to you.

STATEMENT OF ROGER L. HEYMANN, CPA, HEYMANN, LOEB & COHEN, ROCKVILLE, MD

Mr. HEYMANN. I am here to testify on the targeted jobs credit and how it is affected by the alternative minimum tax. An inequity now exists for individuals, partnerships——

Mr. GIBBONS. Do we have a technical amendment on that?

Mr. HEYMANN. There was mention made that there would be an amendment made in regard to section 51 at a later date, but as to whether an amendment is now in, I cannot answer that.

Mr. GIBBONS. I am asking, did we make a mistake. Are you just asking for a change in the law because you think it ought to be different? I don't want to hear a lot of nontechnical, noncorrective-type of things.

Mr. HEYMANN. I can get right to the point.

Mr. GIBBONS. OK.

Mr. HEYMANN. The add-on—the alternative minimum tax is an alternative tax to the regular tax in which you compute two taxes of which you take the higher. Now the problem with the targeted job credits is that you have to subtract the credit from wages and that increases income which has generated an adjustment for which there is no tax benefit. There appears to be some problem with regard to the alternative minimum tax as it applies to it.

If you cannot take the targeted job credit and you carry it over you have to pay an alternative minimum tax on the credit adding back to the income of an individual, subchapter S corporation or partnership. We have here a disincentive for the use of the credit.

Mr. GIBBONS. Do you think we made a mistake in that? Are you trying to say that we didn't know what we were doing when we levied the general tax or the targeted job credits?

Mr. HEYMANN. There have been other technical corrections in which the credit was permitted to be carried over. When the original bill was passed, the credit was not permitted or the investment credit or the WIN credit or targeted jobs credit were not——

Mr. GIBBONS. You are saying you would like the targeted job credit not be included as an offset against the minimum tax?

Mr. HEYMANN. I am saying that when you cannot use the credit you should not be paying an alternative minimum tax by adding that amount of the credit back to income. Therefore we are paying tax on a credit we cannot take and a cash basis taxpayer in order to have a Targeted Job Program in his company is penalized by having it because he has to pay an alternative minimum tax, but has no use of the credit, so it is a catch-22.

Mr. GIBBONS. How many people are caught in this?

Mr. HEYMANN. My experience with the targeted jobs credits——

Mr. GIBBONS. Who are you representing?

Mr. HEYMANN. The committee from employment opportunities.

Mr. GIBBONS. Who are they?

Mr. HEYMANN. They are a nonprofit organization in Washington. I have a number of clients who have used the credit. Since 1979,

when we first passed the alternative minimum tax there have been changes on the use of credit and how it applies to the alternative minimum tax. These clients have found it more expensive to use the Targeted Credit Program.

Large corporations do not have the problem because they do not have a similar alternative minimum tax that individuals have, so it has put the companies who have had programs in the innercity themselves and been able to train people on programs which have work——

Mr. GIBBONS. You are talking really about individuals rather than corporations?

Mr. HEYMANN. Yes, Mr. Chairman.

What happens if it is a partnership sub S, it passes through to the individual so the primary consequence is to the individual. I have seen individuals who have had their taxes increased because of the credit and I don't think it was the intent of the Congress to discourage the use of the credit, yet keep renewing the credit.

Mr. GIBBONS. Is there anything in the technical corrections bill that is now pending before the Congress that straightens out your problem?

Mr. HEYMANN. No, sir.

Mr. GIBBONS. Are there questions from the other members here? OK.

[The prepared statement follows:]

STATEMENT OF ROGER L. HEYMANN, CPA, ROCKVILLE, MD

Dear Mr. Chairman and members of this distinguished committee, I am Roger L. Heymann, CPA and I appearing as an expert witness in regard to the targeted jobs credit and the alternative minimum tax. I am a certified public accountant practicing in Maryland, District of Columbia, and New York. I have been practicing since 1972 and also a member of the American Institute of Certified Public Accountants.

TARGETED JOBS CREDIT

An inequity now exists for individuals, partnerships, and S corporations, in regards to the wage add on provision of the targeted jobs credit. If not remedied this inequity will discourage the use of the credit for unincorporated businesses and S corporations. The alternative minimum tax of individuals will apply to the credit although the tax benefit of the credit may not be realized for years.

In an attempt to encourage the employment of certain difficult to employ or economically disadvantaged persons, Congress enacted legislation to give business employers the incentive to hire members of certain "targeted" groups. This is the "targeted jobs credit" covered under various parts of sections 51 and 53 of the Internal Revenue Code. This credit now falls under a "general business credit".

The treatment of the credit has changed from time to time. It has either been treated similar to the foreign tax credit, reducing the alternative minimum tax, or has not been available to offset the alternative minimum tax. Congress has finally decided that credits not attributable to prior tax payments should not be allowed as alternative minimum tax offsets.

The taxpayer will not enjoy the full tax benefit of the targeted jobs credit (a non-refundable credit) which is otherwise allowable for the taxable year against regular tax. Congress has permitted an election 51(J)(1) and udner 55(C)(3) permits an additional carryover of a non-refundable tax credit equal to the tax benefit of the credit lost due to the imposition of the alternative minimum tax.

There is a unique problem which results from the intent of Congress. The employer's deduction for wages paid must be reduced by the full amount of the targeted jobs credit, without regard to the availability of the full tax benefit. We have converted the unused credit into a tax preference item for individuals of small businesses, partnerships, and S corporations. A cash basis taxpayer will be subject to 20% of targeted jobs credit although he has received no cash benefit in the year the credit or job training was realized. In effect, potentially making the credit into a loss gen-

erated by the training of the special individuals. An add on of $1.00 of wage adjustment can create a 20 cent A.M.T. without the use or benefit of the credit. The election not to use the credit does not appear to encourage the original intent of Congress since the A.M.T. can potentially exist for all future tax years.

The targeted jobs credit is unique to the other non-refundable credits in regards to the wage provision and should be treated differently. The training and generation of jobs also is unique to the credit where it will save many government dollars by employers training the potentially unemployable. I believe Congress agrees with me on both these points.

The solution to this problem is that Form 6251 be amended and Congress permit the unused credit to be an adjustment either reducing or increasing the A.M.T. taxable income. A line similar to line 2(e) of form 6251 would be a good way to approach this adjustment.

An approach similar to 55(e) (the net operating loss provision) in order to arrive at the alternative tax targeted job credit to the extent the credit creates a tax preference increase in income.

The unused credit can be an alternative minimum tax itemized deduction. When used in the future, it can be an addition to the Adjusted Gross Income.

I hope you will consider my testimony as I have worked with many companies that have made the targeted jobs credit work in practice and have found that we have contributed to keeping the U.S.A. employed. I am very grateful for you permitting me to share my views.

Form 6251. Alternative Minimum Tax Computation.

Form **6251**
Department of the Treasury
Internal Revenue Service

Alternative Minimum Tax Computation

▶ Attach to Forms 1040, 1040NR, 1041 or 990-T (Trust).

OMB No. 1545-0227
1984
32

Name(s) as shown on tax return | Identifying number

1 Adjusted gross income from Form 1040, line 33 or Form 1040NR, line 32 (see instructions)			1	
2 Deductions (see instructions)				
a (1) Medical and dental expense from Schedule A, line 5	2a(1)			
(2) Multiply Form 1040, line 33 by 5% (.05)	2a(2)			
(3) Subtract line 2a(2) from line 2a(1). (If zero or less, enter zero)		2a(3)		
b Contributions from Schedule A, line 18		2b		
c Casualty and theft losses from Schedule A, line 19		2c		
d Qualified interest on property used as a residence from Schedule A, line 11		2d		
e (1) Interest, other than line 2d above, from Schedule A, line 14	2e(1)			
(2) Net investment income (If zero or less, enter zero)	2e(2)			
(3) Enter the smaller of line 2e(1) or line 2e(2)		2e(3)		
f Gambling losses to the extent of gambling winnings from Schedule A, line 22		2f		
g Estate tax allowable under section 691(c) from Schedule A		2g		
h Add lines 2a(3), b, c, d, e(3), f, and g			2h	
3 Subtract line 2h from line 1			3	
4 Tax preference items				
a Dividend exclusion		4a		
b 60% capital gain deduction		4b		
c Accelerated depreciation on nonrecovery real property or 15 (or 18)-year real property		4c		
d Accelerated depreciation on leased personal property or leased recovery property other than 15 (or 18)-year real property		4d		
e Amortization of certified pollution control facilities		4e		
f Mining exploration and development costs		4f		
g Circulation and research and experimental expenditures		4g		
h Reserves for losses on bad debts of financial institutions		4h		
i Depletion		4i		
j Incentive stock options		4j		
k Intangible drilling costs		4k		
l Add lines 4a through 4k			4l	
5 Alternative minimum taxable income (add lines 3 and 4(l)) (short period returns, see instructions)			5	
6 Enter: $40,000, if married filing joint return or surviving spouse $30,000, if single or head of household $20,000, if married filing separate return or estate or trust			6	
7 Subtract line 6 from line 5. If zero or less, do not complete the rest of this form			7	
8 Enter 20% of line 7			8	
9 Amount from Form 1040, line 50 or Form 1040NR, line 51 (Do not include Form 1040, line 39 or Form 1040NR, line 41.) (estates and trusts, see instructions)			9	
10 Subtract line 9 from line 8. If zero or less, enter zero			10	
11 Foreign tax credit			11	
12 Alternative minimum tax (subtract line 11 from line 10). Enter on Form 1040, or Form 1040NR, line 52, Form 1041, line 32, or Form 990-T, page 1, line 14			12	

Instructions

(Section References are to the Internal Revenue Code)

Paperwork Reduction Act Notice.— We ask for this information to carry out the Internal Revenue laws of the United States. We need it to ensure that taxpayers are complying with these laws and to allow us to figure and collect the right amount of tax. You are required to give us this information.

Who Must File.—File this form if: (a) You are liable for the alternative minimum tax; or (b) you have one or more tax preference items on lines 4c through 4k; or (c) you have an amount on line 2e(3), and line 2e(2) includes income other than interest and dividend income.

Individuals, estates or trusts may be liable if their adjusted gross income plus tax preference items listed on line 4 total more than line 6.

For more information, see **Publication 909, Alternative Minimum Tax.**

Minimum Tax Deferred From Earlier Year(s).—If a net operating loss carryover from an earlier year(s) reduces taxable income for 1984, and the net operating loss giving rise to the carryover resulted in the deferral of minimum tax in that earlier year(s), all or part of the deferred minimum tax may be includible as tax liability for 1984. Figure the deferred minimum tax at 15% and complete and attach a 1982 Form 4625, Computation of Minimum Tax—Individuals, lines 14 through 18. You may attach a schedule following the format of Form 4625. Enter the amount from line 18 on Form 1040, line 52, or Form 1041, line 32 and write "Form 4625."

Partners, Beneficiaries, etc.—If you are a:

(1) Partner or shareholder of an S corporation, take into account separately your distributive share of items of income and deductions that enter into the computation of tax preference items.

(2) Beneficiary of an estate or trust, see section 58(c).

(3) Participant in a common trust fund, see section 58(e).

(4) Shareholder or holder of beneficial interest in a regulated investment company or a real estate investment trust, see section 58(f).

Carryback and Carryover of Unused Credits.—It may be necessary to figure the carryback or carryover of certain unused credits. See section 55(c)(3).

(Continued on back)

Mr. GIBBONS. How about Baldwin Securities Corp.—Mr. Tavss. Go ahead.

STATEMENT OF JOHN TAVSS, ESQ., SEWARD & KISSEL, ON BEHALF OF BALDWIN SECURITIES CORP.

Mr. TAVSS. Thank you, Mr. Chairman.

My name is John Tavss. I am an attorney with the law firm of Seward & Kissel in New York City. I am speaking here today on behalf of Baldwin Securities Corp. Baldwin is an investment company which is registered under the Investment Company Act of 1940. It has approximately 3,300 shareholders. Baldwin has been and continues to be a personal holding company under the tax law because over half of its shares are deemed to be owned by the members of a single family.

I would like to bring to the attention of the committee a technical problem raised by the provisions of the Tax Reform Act of 1984 that relates to regulated investment companies.

Prior to the Tax Reform Act, a personal holding company such as Baldwin could not qualify as a regulated investment company and therefore had to pay tax at both the corporate and shareholders level. This was true even though the personal holding company met all the other requirements for regulated investment company status. Accordingly, a personal holding company could not qualify for regulated investment company status which, in general, permits a corporation not to pay tax at the corporate level, but instead passes the tax burden on to its shareholders.

The Tax Reform Act removed the prohibition against personal holding companies qualifying as regulated investment companies. The effective date of the removal of this prohibition is for tax years beginning after December 31, 1982. Therefore, it would appear quite clear that it was the intention of Congress to permit a personal holding company which was on a calendar year taxpayer to be able to qualify as a regulated investment company for its 1983 tax year, provided it met all the other regulated investment company qualification standards.

The problem that I would like to point out to the committee results from the fact that the Tax Reform Act was enacted in July 1984, which is after the date for which calendar taxpayers would normally have filed their 1983 returns. The reason why this is a problem is because in order to qualify for regulated investment company treatment a taxpayer must make an election on its tax return to qualify for regulated investment company treatment and also must satisfy certain other requirements that are triggered by the date that the tax returnis filed.

Accordingly, because the new law was not yet enacted, a personal holding company which otherwise met the regulated investment company qualification standards could not have elected to be qualified as a regulated investment company for its 1983 tax year if it filed its return on March 15, 1984, which is the regular due date for a 1983 corporate tax return. It is not clear that a corporation which already has filed a return on March 15, 1984 can cure this problem by filing an amended return.

Ironically, if such a personal holding company had filed for an automatic extension to file its 1983 corporate tax return until September 15, 1984, it could qualify as a regulated investment company.

The technical corrections bill as it is presently drafted does not address this problem. I am proposing a technical amendment that would correct this problem by permitting the personal holding company to be able to make the regulated investment company election and fulfill certain other requirements on the basis of an amended return which would be filed prior to September 15, 1984, which is the same day until which such corporation could have received an automatic extension.

I have submitted with my written statement proposed language which solves this problem. In summary, I believe this proposed amendment is purely technical because it merely places a corporation which filed its return on time on March 15, 1984 in the same place it would have been if it had filed for an extension until September 15, 1984. It seems to me unfair to penalize a taxpayer for filing his return on time while rewarding a similarly situated taxpayer who had filed for an extension.

In addition, I believe the proposed technical amendment is consistent with the effective date that Congress established in connection with the repeal of the personal holding company prohibition. The effective date as I noted earlier was for tax years beginning after December 31, 1982, which clearly indicates that a calendar year personal holding company should be able to qualify as a regulated investment company for its 1983 tax year.

As the statute is now written, it may not apply to a personal holding company's 1983 tax year. I hope the committee will seriously consider this proposal, and I welcome any questions that you might have.

[The prepared statement follows:]

STATEMENT OF JOHN TAVSS, ON BEHALF OF BALDWIN SECURITIES CORP.

SUMMARY

Description of Baldwin Securities Corp.

Baldwin Securities Corporation ("Baldwin") is a Delaware Corporation with its principal place of business in New York City. It has been registered under the Investment Company Act of 1940 as a diversified closed-end management investment company since 1950 and has approximately 3300 shareholders. Over 50% of Baldwin's shares are held by one family, making it a personal holding company ("PHC") for federal income tax purposes and, therefore, ineligible to be taxed as a regulated investment company ("RIC") before the Tax Reform Act of 1984 (the "Act").

Problem posed by section 1071 of the Tax Reform Act of 1984

The Act amended subchapter M of the Internal Revenue Code to permit a PHC to qualify for taxation as a RIC for tax years beginning after December 31, 1982. Basically a PHC is taxed at the corporate level on all of its income, including income it distributes to its shareholders. A RIC is not taxed at the corporate level on the income which it distributes to its shareholders.

To qualify as a RIC, a corporation must, in addition to meeting certain other criteria, (i) file with its Federal income tax return for the taxable year an election to be taxed as a RIC, and (ii) distribute to its shareholders at least 90% of its investment income for the taxable year. The distribution may be made either during the taxable year or in the following year if it is declared before the tax return for the taxable year is filed.

The Act was signed into law on July 18, 1984. Accordingly, a PHC which had filed its tax return before July 18, 1984, (a PHC having a taxable year ending December 31, 1983, would file its return on March 15, 1984) could not have elected RIC status on its return because the Act was not yet law. Furthermore, the PHC may have failed to declare the appropriate dividend prior to filing its return based on its belief that it could not qualify as a RIC for 1983. It is not clear under current law whether these problems can be cured by having the PHC elect RIC status on an amended return and declare the appropriate dividend prior to filing such amended return.

Example illustrating the problem

The following example illustrates how the Act may unfairly penalize a corporation which filed a timely return on March 15, 1984, and the need for the requested technical amendment.

Baldwin is a calendar year taxpayer which filed its Federal income tax return for its taxable year ended December 31, 1983, in a timely fashion on March 15, 1984. For 1983, Baldwin could have qualified as a RIC but for the fact that it was a PHC. The Act was signed into law on July 18, 1984. Baldwin, having filed its return on March 15, 1984, could not have elected to be taxed as a RIC because the Act was not law. If Baldwin had applied for an automatic extension of the filing deadline for its 1983 Federal income tax return to September 15, 1984 and filed its return on that date, it could have elected to be taxed as a RIC for 1983 and it could have declared distributions up to September 15, 1984, in order to comply with the 90% distribution test.

Proposed technical amendment

A technical amendment to the Act should be enacted which would clarify that a PHC which had already filed its 1983 tax return at the time the Act became law could qualify as a RIC by electing RIC status on an amended return filed for 1983 on or before September 15, 1984 and by declaring the appropriate dividend for 1983 prior to filing such amended return. Such an amendment would be procedural and would not have a substantive effect on the provisions of the Act.

STATEMENT

Mr. Chairman, members of the Committee, thank you for this opportunity to present testimony concerning technical corrections to the Tax Reform Act of 1984 (the "Tax Reform Act"). I am John Tavss of the New York City law firm of Seward & Kissel and I am testifying today on behalf of Baldwin Securities Corporation ("Baldwin") in favor of a technical amendment to Section 1071 of the Tax Reform Act. Section 1071 removed the prohibition that prevented a personal holding company ("PHC") from being eligible to be taxed as a regulated investment company ("RIC") and made this amendment effective beginning in tax years after December 31, 1982.

Baldwin is a Delaware corporation with its principal place of business in New York City. It has been registered under the Investment Company Act of 1940 as a diversified closed-end management investment company since 1950 and has approximately 3300 shareholders. Over 50% of Baldwin's shares are held by one family, making it a PHC for federal income tax purposes and, therefore, ineligible to be taxed as a RIC before the Tax Reform Act. In order to avoid the penalty tax on PHCs, Baldwin has annually distributed all of its short-term capital gains and income from dividends and interest, exclusive of expenses and taxes, to its shareholders. Baldwin has accumulated its long-term capital gains.

A corporation that has not qualified as a RIC will be taxed at the corporate level on all of its income, including income it distributes to its shareholders. A RIC, on the other hand, is not taxed at the corporate level on income which it distributes to its shareholders. Thus, qualifying as a RIC for income tax purposes is a significant economic benefit.

In order to be eligible to be taxed as a RIC for Federal income tax purposes for a taxable year, a corporation must meet the requirements imposed by Sections 851(a), 851(b) and 852(a) of the Internal Revenue Code of 1954, as amended (the "Code"). Among those requirements are: (1) that the corporation is a registered investment company under the Investment Company Act of 1940; (2) that the corporation file with its Federal income tax return for the taxable year an election to be taxed as a RIC or that such election have been filed for a previous taxable year, and (3) that the corporation distribute for the taxable year 90% of its "investment company taxable income" and 90% of its tax-exempt interest income (the "90% Distribution Test").

A PHC which was a registered investment company under the Investment Company Act of 1940 for its taxable year beginning after December 31, 1982, and which met the other substantive requirements for RIC status for such taxable year, still would not qualify as a RIC unless it made an election to be taxed as a RIC on its Federal income tax return and unless it met the 90% Distribution Test for such taxable year. Any such corporation which filed its return before July 18, 1984, the date of enactment of the Act (a corporation having a taxable year ending December 31, 1983 would file its tax return by March 15, 1984), could not have made a RIC election on its return because, based on the law which existed at the time the corporation filed its return, a PHC would not qualify as a RIC. Under current law, it is not clear whether an election to be taxed as a RIC could be made by such a corporation on an amended Federal income tax return filed after the date of enactment of the Tax Reform Act.

Furthermore, such a corporation may not be able to meet the 90% Distribution Test since, as a PHC, it probably would have distributed for its taxable year ended prior to the enactment of the Tax Reform Act an amount equal to its "investment company taxable income" less the Federal income taxes attributable thereto.[1] Such a corporation would be able to meet the 90% Distribution Test if it is permitted to make an additional dividend relating back to such taxable year pursuant to Code Section 855.[2] However, Code Section 855 requires that the additional dividend be declared prior to the corporation's filing its Federal income tax return for a taxable year (including extensions) and that the corporation elect on its Federal income tax return to have the dividend considered paid during the prior year for purposes of the 90% Distribution Test. If such a corporation had filed its return for a taxable year which began after December 31, 1982 and ended prior to the enactment of the Tax Reform Act it is not clear under current law whether such corporation could qualify as a RIC for 1983 by electing to utilize the Code Section 855 procedure in connection with an amended return filed after the date of enactment of the Tax Reform Act.

It is our recommendation that a technical amendment to the Act be adopted as part of H.R. 1800 which would expressly permit a PHC which otherwise met the requirements for RIC status with respect to its first taxable year beginning after December 31, 1982 and which had filed its Federal income tax return for such taxable year prior to the enactment of the Tax Reform Act: (1) to elect to be taxed as a RIC for such taxable year on an amended Federal income tax return filed no later than September 15, 1984, the date to which an automatic extension for filing an income tax return would have been granted; and (2) to declare an additional dividend and elect on its amended return pursuant to Code Section 855 to relate that dividend back to such taxable year for purposes of the 90% Distribution Test. These provisions could be enacted by amending Section 1071(a)(5) of the Tax Reform Act. A proposed amendment is attached to this Statement.

We believe the proposed technical amendment is clearly consistent with the intention of Congress to have the repeal of the PHC prohibition for RICs be effective for taxable years beginning after December 31, 1982. Unless the steps described above could be taken in connection with amended returns the December 31, 1982 effective date set by Congress with respect to the RIC provisions relating to PHC's would be meaningless to certain investment companies which had filed their 1983 return prior to the enactment of the Tax Reform Act.

Our proposed technical amendment eliminates a potential unfairness against certain corporations. For example, Baldwin is a calendar year taxpayer which filed its Federal income tax return for its taxable year ended December 31, 1983 on March 15, 1984. For 1983, Baldwin could have qualified as a RIC but for the fact that it was a PHC. When it filed its return on March 15, 1984 it could not have elected to be taxed as a RIC because the Tax Reform Act was not enacted until July 18, 1984. However, if Baldwin had applied for an automatic extension to file its 1983 Federal income tax return until September 15, 1984, it could have elected to be taxed as a RIC for 1983 and it could have used the Code Section 855 procedure for relating back dividends in order to comply with the 90% Distribution Test merely because the due date of its 1983 Federal income tax return was extended until September

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[1] If Federal income taxes for such taxable year were more than 10 percent of "investment company taxable income," the 90 percent Distribution Test would not be met.

[2] Pursuant to Code Section 855, a RIC is permitted to meet the 90 percent Distribution Test for a taxable year by paying an additional dividend in the following taxable year provided (i) that the declaration of such additional dividend is made before the due date (including extensions) for filing its tax return for the taxable year and (ii) that an election is made on such tax return designating what portion of such dividend is to be treated as paid in the taxable year.

15, 1984. It would appear to us very unfair to penalize a corporation which filed its 1983 Federal income tax return on March 15, 1984 while rewarding a corporation which applied for an extension to file its 1983 Federal income tax return until September 15, 1984.

We do not believe that the proposed amendment will affect other provisions of the Tax Reform Act relating to RICs. The Tax Reform Act, in addition to eliminating the prohibition against PHCs qualifying as RICs, imposed the requirement that a RIC distribute any earnings and profits which it accumulated during those years in which the corporation was not a RIC. The requirement that a RIC distribute its accumulated earnings and profits from non-RIC years does not, however, apply to a corporation which meets all of the other RIC qualification standards for each of its taxable years ending after November 8, 1983. Thus, a calendar year corporation which met the RIC qualification standards for its year ended December 31, 1983, could qualify as a RIC in 1983 and in subsequent years without distributing its accumulated earnings and profits from non-RIC years.

The Tax Reform Act permits certain registered investment companies which could not previously qualify as RICs because they were PHCs and which filed for the automatic extension to September 15, 1984, to file their 1983 tax returns to qualify as RICs for 1983 and for subsequent years without distributing their accumulated earnings and profits. However, a company such as Baldwin which filed a timely 1983 tax return on March 15, 1984 (i.e., before the Tax Reform Act was enacted) and which did not file for the automatic extension to September 15, 1984, might not qualify as a RIC for 1983, and might not be able to qualify as a RIC for subsequent years without distributing its accumulated earnings (consisting of long term capital gains) from non-RIC years.

The rationale for the requirement that a RIC distribute its accumulated earnings and profits from non-RIC years is to prevent certain operating businesses which have accumulated operating profits from being able to sell their operating assets and to then qualify for treatment as RICs without distributing their operating profits. In addition, there was concern that so-called "tax-managed funds" (i.e., investment companies which accumulated large amounts of dividend income without paying corporate tax thereon because of the 85% dividends received deduction) could become RICs without distributing such accumulated dividend income. These concerns do not apply to Baldwin because Baldwin has been a registered investment company since 1950, not an operating company, and has distributed its dividend income every year to avoid the PHC tax penalty. The fact that Baldwin has accumulated long term capital gains should not be relevant because a RIC is permitted under the Code to accumulate long term capital gains without distributing such gains to its shareholders.

We believe there are only a few corporations who face the problem outlined in this statement. The primary reason for this is that there are very few corporations registered under the Investment Company Act of 1940 which are PHC's. It is apparent that Congress intended that such companies be able to qualify as RICs and our proposed technical amendment will carry out this intent. Furthermore, such a technical amendment could avoid unnecessary litigation on this issue.

In conclusion, we believe a technical amendment of the type suggested above clarifies the problem we have raised and promotes the clear intention of the Tax Reform Act provisions relating to repeal of the prohibition on PHC's qualifying as RICs.

Thank you for this opportunity to present our views on H.R. 1800. We would be pleased to provide the Committee with any further information it may require to resolve the issues addressed in our Statement.

PROPOSED TECHNICAL AMENDMENT TO SECTION 1071 OF TAX REFORM ACT OF 1984 RELATING TO REGULATED INVESTMENT COMPANIES

1. Section 1071(a)(5) of the Tax Reform Act of 1984 shall be amended by adding the following transitional rules as subsections (E) and (F).

(E) TIME FOR MAKING ELECTION FOR FIRST TAXABLE YEAR BEGINNING AFTER DECEMBER 31, 1982.—For purposes of section 851(b)(1), a corporation which was a personal holding company for its first taxable year beginning after December 31, 1982 shall be considered for such taxable year to have made the election required by section 851(b)(1) if such an election is made on an amended return for such taxable year filed not later than September 15, 1984.

(F) SPECIAL TIME FOR ELECTION RELATING TO DIVIDENDS PAYABLE WITH RESPECT TO FIRST TAXABLE YEAR BEGINNING AFTER DECEMBER 31, 1982.—For purposes of this

chapter, if a regulated investment company which was a personal holding company for its first taxable year beginning after December 31, 1982—

(1) declares a dividend not later than September 15, 1984, and

(2) distributes the amount of such dividend to its shareholders not later than December 31, 1984,

then the amount so declared and distributed shall, to the extent the company elects in an amended return filed not later than September 15, 1984 for its first taxable year beginning after December 31, 1982, be considered as having been paid during such taxable year and shall be considered an amount to which subsection (a) of section 855 is applicable.

Mr. GIBBONS. Thank you.

Are there any questions of any of these witnesses?

Thank you, gentlemen.

The next panel of witnesses are Lord Howard, the Honorable Govert van Tets, Mr. Greenberg and Mr. Maclean, who are here I guess to talk about FIRPTA.

STATEMENT OF LORD MARK FITZALAN HOWARD, CHAIRMAN EMERITUS, ASSOCIATION OF INVESTMENT TRUST COMPANIES OF THE UNITED KINGDOM

Lord HOWARD. Thank you, Mr. Chairman.

Mr. Chairman and members of the committee, I am Mark Fitzalan Howard, and I am pleased to speak on behalf of the Association of Investment Trust Companies of the United Kingdom.

Accompanying me is Hon. Govert van Tets, member of the Senate of the Parliament of the Netherlands, representing the pension fund associations of 11 Western European nations.

By your leave, I will also ask that Mr. Wayne Harmon, seated to the extreme right, who is executive vice president of the Louisiana Association of Independent Producers and Royalty Owners.

Mr. Chairman, my association represents some 170 member companies with approximately 32 percent of their assets or about $6 billion invested in the United States at the close of last year.

Mr. GIBBONS. You have got $6 billion invested in the United States?

Lord HOWARD. Indeed we have, and I hope it will increase.

The Association of Investment Trust Companies would like to address those portions of the Technical Corrections Act which amend the Foreign Investment in Real Property Tax Act, or FIRPTA, as it has become known.

In the interest of preserving the committee's time, I ask that our more complete prepared statement be printed in the hearing record as though read in full.

Mr. GIBBONS. It will be printed.

Lord HOWARD. The proposed Technical Corrections Act amending FIRPTA, we believe, takes bad law and makes it worse not only for us but for U.S. companies which need more capital.

A brief summary of our specific concerns with those FIRPTA provisions is as follows: first of all, withholding. The proposed act is silent on providing for a taxable base to be used in determining tax liability as an alternative to simply withholding 10 percent of the proceeds of a disposition.

Thus in the case of shares disposed of in a transaction which may be subject to FIRPTA, the transferee or withholding agent has no incentive other than to withhold 10 percent.

The bill is also silent on the length of time in which a foreign investor may expect to receive his refund when the amount withheld exceeds his tax liability. While IRS regulations provide that amounts overwithheld may be refunded within 90 days, it also provides that this may be extended in unusually complicated cases.

As publicly traded companies, our members find this burden difficult to justify to their shareholders.

The bill also sets forth conditions under which exemptions from withholding may be sought. None of those proposed conditions address exemptions which our members, who are substantial public companies and whose shares are listed on the U.K. stock exchange, find practical.

Of course, our members would not avoid paying taxes which are properly computed but are justifiably concerned that suffering withholding in excess of their tax liability, particularly in view of the long delay before the excess can be refunded.

Second, Mr. Chairman, the question of interest: H.R. 1800 does not correct the blatant unfairness that interest apparently is not due on funds withheld in excess of tax liabilities despite the IRS requirement that interest and penalties are due on sums awaiting final settlement.

There are many other problems in FIRPTA which H.R. 1800 falls short of addressing, and for that reason, I would attach as part of our submission today a letter of February 27, 1985, addressed to the Commissioner of Internal Revenue from the Association of Investment Trust Companies. This letter outlines a host of practical problems prejudicing our investment attitudes toward the U.S. firms which unfortunately find themselves qualifying as U.S. real property holding companies despite their being neither in the real estate nor in the farming business.

These problems demonstrate that the withholding provisions are drafted with physical property in mind and are clearly inappropriate to disposal of shares with which our members are primarily concerned.

If left unchanged, FIRPTA will seriously inhibit foreign investment in two industries vital to U.S. national defense, namely oil and gas exploration, and high technology.

Our members pay no capital gains tax in the United Kingdom, being subject instead to a totally different tax code, and have no offset for the capital gains tax FIRPTA would impose upon our investments here.

Congress has long pursued a policy of encouraging foreign capital investment in the United States. In 1984, Congress removed the 30-percent withholding on foreign interest as a means of encouraging foreign capital so needed to finance the U.S. deficit.

Mr. Chairman, you have been most kind in allowing me so much time.

I would merely urge that, as your committee views the pending FIRPTA amendments in the technical corrections bill, it does so with a view toward correcting FIRPTA by making it applicable solely to U.S. farmland, as was indeed the intent of Congress when FIRPTA was enacted in 1980.

Your farm prices are depressed, your national deficit is massive, your interest rates need to be lowered, your independent oil and

gas exploration and vital high technology industries need foreign capital.

You are already on record as favoring the removal of obstacles to our investment such as the 30-percent withholding tax on foreign interests. Thus, Mr. Chairman, by modifying FIRPTA as its original author, Senator Wallop, has proposed, those Anglo-American investment lines which have been in place for over a century and which have so greatly benefited both of our countries, they will be preserved.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT ON BEHALF OF THE ASSOCIATION OF INVESTMENT TRUST COMPANIES OF THE UNITED KINGDOM

Mr. Chairman and members of the committee, I, Mark Fitzalan Howard, Director, The Fleming Overseas Investment Trust PLC, am pleased to appear today on behalf of the Association of Investment Trust Companies (AITC) in support of legislation to repeal or modify FIRPTA.

The Association respectfully submits, Mr. Chairman, that Congress in enacting FIRPTA has exceeded its intention to tax non-American acquisition of agricultural lands and has penalized instead not only many American companies eager to utilize international capital, but also its friends in the U.K. investment community as well. In addition, the barrier which FIRPTA imposes is inconsistent with current U.S. policy of encouraging the inflow of capital to reduce interest rate pressures and facilitate financing the U.S. deficit.

The AITC represents some 170 member firms, having approximately 32 percent of their assets or $6 billion invested in the U.S. at the close of last year. Traditionally a considerable proportion of our U.S. investments has been in oil and gas exploration, and more recently in high technology and venture capital companies. We have invested in many unquoted companies in these areas at early stages in their lives and in this way we have provided much needed capital for them. To avoid double taxation on their shareholders, U.K. investment trust companies (ITCs), along with other investors such as pension funds, are exempt from U.K. tax on capital gains realized within the fund and therefore have no U.K. tax liability against which to offset any liability to FIRPTA. The advent of FIRPTA has therefore meant that investments in such ventures which qualify as "real property holding companies" has become considerably less attractive to us not only because, unlike our other investments in the U.S., they are taxed on profits on their realisation, but also because of the onerous withholding requirements in connection with them. We submit that it is not in the national interest of the U.S. that it should be deprived of valuable capital for such enterprises because of the existence of FIRPTA. In any case, although not having precise knowledge, we very much doubt if FIRPTA would yield significant revenues.

The U.K. investment trust movement, with assets of around $19 billion, is one of the largest collective investment institutions of its kind in Europe investing in equities. The U.K. ITCs have been in existence for over 100 years and this method of spreading the risks of equity investment throughout the world is greatly valued by private and institutional shareholders alike. ITCs have always had a substantial proportion of their total assets in U.S. securities held as long-term portfolio investments; they are not short-term opportunistic investors. There are approximately 650,000 shareholdings in companies within the movement of whom 85 percent by number are private investors and 15 percent are institutional, the latter in turn representing ultimately a further vast number of private individuals who are indirect investors in investment trusts through unit trusts, insurance companies or pension funds, etc. This Association is therefore concerned that the millions of private individuals invested directly or indirectly in investment trust companies should not be harmed by FIRPTA, even if unintentionally.

The U.K. ITCs are not trusts in the legal sense but are joint stock companies incorporated with limited liability under the Companies Acts, and having a full listing on the U.K. Stock Exchange. They are closed-end funds formed for the collective investment in shares and securities of monies subscribed as share and loan capital by their members and loan stockholders. Their assets are widely spread among a large number of companies, the average investment usually representing less than one percent of the ITC's assets normally being in the nature of passive portfolio invest-

ments rather than active direct investments. Only occasionally would an investment exceed five percent of the ITCs assets.

Responsibility for running an ITC lies with its Board of Directors, but most now have a relationship with a manager—an individual, partnership, investment management company or the investment management department of a merchant bank—who deals with administration and investment management following the broad objectives set by the Board.

The investor in an investment trust company buys not the underlying assets, but shares in the company that owns them. Private shareholders obtain professional portfolio management and a spread of risk which would generally not be possible from a direct portfolio of their own. Institutional shareholders get the benefit of buying an interest in a ready-made equity portfolio.

The investment policy of an ITC depends on its general objective. Most are general funds, but many concentrate on particular geographical areas such as North America or particular industries such as energy or technology. Some seek to maximize long-term capital growth; some aim for high income.

As ITCs are closed-end companies, their funds available for investment cannot be reduced by redemptions on demand by their shareholders. They can, therefore, take a longer term view of investment opportunities. Their structure is thus ideal for investment in unlisted developing companies and venture capital projects, where the potential returns can reflect the risk if the investor is able to wait for them to mature.

As you know, FIRPTA became law at the close of 1980 and one would surmise that its hasty passage explains why its scope exceeds its intent. The debate which occurred on the floors of both houses of the Congress clearly focused on real estate investments. Indeed it can be fairly stated that the recurring emphasis during Senate and House consideration of the legislation was to tax the gains realized by non-resident on sale or disposition of U.S. real property as well as gains realized from the sale or exchange of an interest in a corporation. trust, or partnership formed to hold U.S. real property interests. Unfortunately, because of the definition published by your Internal Revenue Service (IRS) in the various draft regulations, the scope of the legislation has gone far beyond this simple aim.

AITC member companies do not invest heavily in companies having as their primary business activity the holding or management of real estate. However, they become subject to FIRPTA's onerous requirements by virtue only of investments in companies having certain business assets which meet the law's definition of a "U.S. real property holding company."

In view of the troubled situation in the Middle East, and the fundamental shortage of domestic energy reserves it seems that the U.S. should now more than ever remove any impediment to domestic oil and gas exploration capital. The AITC submits that, unless the effects of FIRPTA are removed, the result will be materially to reduce the finance from outside the U.S. for oil and gas exploration. If FIRPTA takes effect, our investments in oil and gas companies will have to perform significantly better than those in any other country in order to compensate for the tax imposed by FIRPTA for which there is no U.K. relief available to ITC's shareholders.

FIRPTA similarly jeopardizes our investment in high technology and other venture capital companies in the U.S. These companies, I believe, are regarded in America as a vital part of your national defense and that of the free world. Furthermore, they should achieve above average growth to the benefit of the U.S. economy. Because of FIRPTA, ITCs may increasingly turnaway from investing in technology in the U.S. and focus on other areas such as Japan.

In addition, current FIRPTA proposals impose a totally impractical reporting procedure on the U.S. companies within its scope and on their overseas investors. The alternative of withholding poses equally intractable problems.

Many U.S. companies which are not primarily engaged in the real estate business have real proeprty in the course of their normal business and thus fall within the purview of FIRPTA. As a consequence, non-American investors such as ITCs will be subject to unacceptably onerous requirements such as: (1) reporting to their thousands of shareholders their holdings in FIRPTA companies, even if only on a see-through basis; (2) the threat of criminal penalties for failure to file with your Internal Revenue Service (IRS) information only available from U.S. firms over which they have no control; (3) requiring their shareholders to file returns with your IRS of their U.S. property interests held indirectly through the ITCs; (4) restricting the use of precious capital temporarily and without interest as a consequence of withholding, which diverts funds otherwise available for investment.

In addition, the valuation of assets held by oil and gas exploration and high technology companies is simply not practical when compared to real estate. How can the value of shares in companies having "non-business" assets, yet deemed under FIRPTA to be "real property holding companies", be precisely valued so that the tax liability on the gain can be determined? What is the precise value of a partially proven oil or gas reserve and what is the value of a high technology company's patent rights and R & D know-how? Yet these valuations are critical in determining whether or not the company is within the scope of FIRPTA.

Set out below are just three examples received from our member companies where FIRPTA is already affecting their investment decisions.

(A) One group manages several oil and gas companies which are resident in the U.S. for tax purposes but are owned by U.K. resident bodies. It had arranged to transfer the residence of these funds into the U.K. at this relatively early state in their life without material U.S. taxation in order to avoid the double tax effects of FIRPTA. In view of the possibility of the repeal of FIRPTA due to introduction of S. 758 it has transferred the residence of these companies, with the consequent loss to the federal and state taxing authorities of revenue in the future. It is actively expanding this side of its business and any future companies formed will, unless FIRPTA is repealed, also be resident in the U.K.

(B) A member invests in high technology companies, mainly outside the U.K. Some of these companies in the U.S. may unexpectedly be caught within the FIRPTA net. The member as a matter of policy now normally refuses opportunities to invest in any such company which may be treated as a U.S. real property holding company.

(C) One group has indicated that, if FIRPTA remains in its present form, it would have to seriously consider disposing of its holdings in companies within the FIRPTA net before the withholding requirements come into effect.

Mr. Chairman, the Deficit Reduction Act 1984 tax bill phased out the current 30 percent withholding tax applicable to interest payments due to non-American investors. Hearings occurred on May 1, 1984 in the House Ways and Means Committee on H.R. 3025 to repeal the 30 percent withholding tax. The rationale for the end to this tax, supported by the U.S. Treasury in House hearings, rests on the need to remove American impediment to foreign investment. We submit that retaining FIRPTA as currently written is inconsistent with present Congressional and Administration thinking.

Congress exempted capital gains on foreign investors in 1936, basing its action on the following reasons: "Such a nonresident alien will not be subject to the tax on capital gains . . . as at present, it having been found administratively impossible effectually to collect this latter tax. It is believed this exemption from tax will result in considerable additional revenue . . . from the income tax in the case of persons carrying on the brokerage business."

The above text was taken from Senate Report 2156, 2nd Congress, 2nd Session (1936).

Indeed, the encouragement of foreign investment is also a matter of public policy at the state level. Many states are actively seeking non-American investment through trade missions, advertising, tax incentives, etc. Hardly a year goes by without one of your Governors visiting capitols abroad to seek non-American capital.

The Association of Investment Trust Companies
Park House (6th Floor) 16 Finsbury Circus London EC2M 7JJ.

Telephone No. 01-588 5347 Facsimile No. 01-638 1803

27th February 1985

Commissioner of Internal Revenue
Attention: CC:LR:T (LR-151-84)
Washington DC 20224
United States of America

Dear Sir

Foreign Investment in Real Property Tax Act 1980 (FIRPTA)

The Association represents some 170 member companies with approximately 32% of their assets or about $6 billion invested in the US at the close of last year. Traditionally a considerable proportion of our members' US investments has been in oil and gas exploration and in high technology and venture capital companies. We have invested in many U.S. unquoted companies in these areas at early stages in their lives and in this way have provided much needed capital for them.

For this reason, the introduction of FIRPTA is likely to cause serious problems for our member companies. We are therefore concerned at the implications of the withholding provisions, upon which we wish to raise a number of points.

The aim of the withholding system is, or should be, to ensure that the IRS receives just the right amount of tax due to it without imposing financial penalties or excessive compliance costs on the taxpayer. The temporary regulations as drafted will involve excessive payments to the IRS, leading to severe financial penalties and compliance costs on our member companies.

The imposition of a 10% withholding under section 1445-1T will in our view produce an excessive amount of tax for the IRS, as it is based on gross proceeds and will apply on all sales, even where made at a loss. There will be a large number of occasions upon which it will be excessive for our members in view of the extension of the definition of a US Real Property Holding Company to cover many unlisted oil and gas and high technology companies; sales of the shares of such companies at a loss or at a minimal profit could easily occur. Our members will therefore suffer financial penalties from the loss of interest on the over-withheld amount and from the loss of the use of that money for reinvestment, coupled with the compliance costs of the complicated early refund procedure.

The points of particular concern to us are as follows:

(a) The lengthy refund procedure.

(b) The treatment of interest.

(c) The problems arising from the affidavit procedure.

(d) The validation of affidavits.

(e) The difficulties of obtaining withholding certificates.

(f) The penalties associated with the Agreement procedure.

(1) The lengthy refund procedure

The early refund procedure involves the taxpayer in applying for a withholding certificate under section 1445-3T upon which the IRS will act within 90 days; however sub-section 3T(a) provides that "in unusually complicated cases" this time may be extended. It is submitted that 90 days or more is far too long for the taxpayer to have to wait. Moreover Sub-section 3T(f) provides that the IRS will respond to a claim for refund within 90 days. If, therefore, application for a withholding certificate cannot be made until the transaction has been completed, as will often be the case particularly when dealing with the sale of shares, the taxpayer may have to wait up to 180 days, or even longer in complicated cases, before the return of the amount over-withheld. This imposes an undue financial penalty on the taxpayer.

(2) The treatment of interest

Sub-section 3T(f) makes it clear that no interest will be paid by the IRS on sums repaid under the early refund procedure. In contrast Sub-section 3T(e)(ii) requires an "Agreement" for a withholding certificate to cover the payment of interest on the amount that would otherwise have been withheld between the date of the agreement and the date on which payment of the tax will be due. It cannot be equitable for the IRS to receive interest on amounts withheld but not to pay interest on the excess when it is refunded.

An additional problem is that the withholding will presumably be in dollars. Our members will therefore be at risk on movements in the sterling/dollar exchange rate between the date of sale and the date of refund. Any hedging against this risk would involve another financial cost.

(3) The problems arising from the affidavit procedure

Under section 1.1445-2T, the transferee or his agent must withhold on the purchase of unlisted investments unless he has an affidavit that the unlisted company is not a USRPHC or that the vendor is a US resident. As the transferor alone is the one to suffer if the transferee applies withholding unnecessarily, the transferee has no incentive to ensure that he receives the necessary affidavits from non-USRPHCs; he may indeed seek to protect himself from the penalties set out in sub-section 1T(e) by applying withholding in any case of doubt or difficulty. The transferor appears to have no redress other than to begin the lengthy proceedings for the refund of over-withheld tax, involving a loss of interest on the amount unnecessarily withheld. The withholding provisions are thus applied on the basis that the foreign vendor is taxable unless those over whom he has no control have taken the necessary action to establish otherwise: this seems a perversion of natural justice.

(4) The validation of affidavits

Section 1.1445-4T imposes a duty on the transferor's and the transferee's agents to notify the transferee if the agent knows that a non-US real property interest statement or a non-foreign certification is false; the transferee is then required under sub-section 2T(c) to apply withholding. It will be difficult for a transferee or his agent to validate such affidavits, particularly if he is a non-US resident.

(5) The difficulties of obtaining witholding certificates

In view of the above points, it is essential that the procedure for obtaining withholding certificates under section 1.1445-3T is made quick and easy. This appears to be far from the case. the procedure most likely to be used by investment trust companies is that set out in sub-section 3T(e) for an "Agreement for the payment of the tax". The form of contract between the IRS and the taxpayer is not specified and it is not clear whether a separate contract is required for each transaction or whether a general contract covering any relevant transactions over a stated period would be acceptable.

The other side of such "Agreements" is the requirement under sub-section 3T(e) for the provision of security. The one of most likely interest to Members of this Associaton is that for "Guarantees" under sub-section 3T(e)(v). It is not clear exactly what form such a guarantee should take. I have therefore sought clarification from Mr Robert E Culbertson on the following points in a letter to him dated 5th February 1985:

(i) As Members of this Association are substantial public limited companies, whose shares are listed on the United Kingdom Stock Exchange, would they be able to obtain a withholding certificate excusing withholding on production of evidence of status and on undertaking to pay any tax due under FIRPTA?

(ii) Would such an undertaking have to be given on each occasion a sale giving rise to FIRPTA was contemplated, or would a general undertaking be sufficient?

(iii) Where the taxpayer is a subsidiary of a UK listed public limited company, would a guarantee by the listed parent of any tax due under FIRPTA by its subsidiary be acceptable to the IRS for this purpose?

Although no formal clarification of these points has yet been received, it is understood that the IRS's ruling is likely to be that Guarantees must be sought thirty days prior to settlement of a transaction and must be offered on a transaction-by-transaction basis. It will clearly be impractical for many if not most transactions involving shares for sufficient details to be known 30 days beforehand for the necessary Guarantee application to be made in time. For example, resolutions may be proposed by a USRPHC for a reconstruction or merger involving a voluntary or involuntary realisation. Where the period of notice for such resolutions is less than 30 days, as in the UK, the investor will have no chance of entering into a contract with the IRS. The useful simplification provided by the Guarantee procedure is therefore likely to be denied in practice to our member companies, leading to an increase in the compliance costs for them and for

We accordingly urge that responsible listed foreign companies should be able to obtain a withholding certificate excusing withholding on provision of a general undertaking to the IRS to pay any tax due under FIRPTA. This undertaking would apply for a stated period and would cover any FIRPTA transactions within that period.

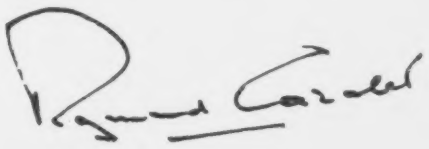
(6) The penalties associated with the Agreement procedure for a witholding certificate

As mentioned above under (2), sub-section 3T(e)(ii) requires an "Agreement" to cover the payment of interest on the amount that would have been withheld between the date of the agreement and the date when payment of the tax is due. Sub-section 3T(e)(iii) also requires the agreement to provide for the payment of an additional 25% over the taxpayer's maximum tax liability to cover interest and penalties which would apply on a failure to file a return and pay the tax.

The financial penalties imposed by these sub-sections are totally unreasonable and should be removed.

It is clear that the withholding regulations will add significant financial penalties and compliance costs to the burdens of FIRPTA on our member companies. The result will be a reluctance to invest in companies or assets giving rise to FIRPTA and a reduction in the yield which might have been forecast from this tax.

Yours faithfully



R P St G Cazalet
Chairman

Mr. GIBBONS. I appreciate that.

I want to say I have been intimately involved in this mess that we call FIRPTA. I opposed it, but got outvoted. I devoted my time to getting it repealed and trying to fix it so it would be workable. I have made it a little more workable, but it still has serious problems and still discourages foreign investment in this country.

I am now faced with the dilemma that people who put FIRPTA on in the first place want to take it off. I agree, but once we get one of these things on the books, they are terrible to get loose.

Maybe we can straighten this out somehow. It is obvious that instead of raising revenues, it is costing revenue by raising interest rates and discouraging legitimate foreign investment in this country. It is a tough one.

Mr. GIBBONS. Mr. van Tets.

STATEMENT OF HON. GOVERT O.J. VAN TETS, CHAIRMAN, EUROPEAN FEDERATION FOR RETIREMENT PROVISION, AND MEMBER, UPPER CHAMBER, PARLIAMENT OF THE NETHERLANDS

Mr. VAN TETS. Thank you, Mr. Chairman.

My name is Govert van Tets, and I am here on behalf of the European Federation for Retirement Provision, which consists of pension fund associations in a number of European nations.

I ask to be allowed to file a more complete statement for the record.

We support the views expressed by the British Association of Trust Cos. and, as institutional investors in America, find it hard to believe that FIRPTA would technically be improved by H.R. 1800 so as not to act as a major deterrent, in one way or another, in any way other than by redefinition to make it apply only to farmland, as was the original intention of its sponsors.

Pension funds generally are tax exempt in their countries of residence, and U.S. pension funds that are tax exempt here would also be exempt from taxes in Holland if they invested in real estate in that country.

However, if we invest here, we are subject to not only the FIRPTA tax but to withholding, lack of interest for excess withheld, delays in refunds and other problems which H.R. 1800 fail to cure.

There is ample scope for more long-term bona fide pension fund capital investment in the United States and it should continue if the barriers from such legislation as FIRPTA are redefined, no longer to act as a deterrent to other investment than what it was intended to deal with, if at all.

H.R. 1800 provides a vehicle for Congress to reassess FIRPTA. The main deficiency in H.R. 1800 is that it omits to deal with existing U.S. tax treaties with European trading partners. FIRPTA preempted those treaties as of January 1 last year and it was not possible to renegotiate them before that date.

The Governments of Holland, Britain, West Germany, France, Belgium, and Luxumbourg filed formal protests of this preemption with the Treasury Secretary last year. That letter has gone unheeded.

The Council of Europe has passed a report with a critical note on exactly that point with only a Communist vote against. I will attach the other paragraph to my full statement.

We strongly urge Congress to use the Technical Corrections bill to lift the tax treaty preemption provision of FIRPTA and, if possible, to redefine the scope of the bill to farmland and the like, and have a pronounced general policy of encouraging rather than discouraging more capital investment in the U.S. economy.

Mr. GIBBONS. Thank you.

[The prepared statement follows:]

STATEMENT ON BEHALF OF THE EUROPEAN FEDERATION FOR RETIREMENT PROVISION

Mr. Chairman and members of the committee, my name is Govert van Tets, and I am pleased to appear today on behalf of the European Federation for Retirement Provision (EFRP), in support of legislation to repeal FIRPTA.

The European Federation for Retirement Provision is a federation of the national associations of private pension funds in eight European countries. Private pension funds investing substantially in the U.S. exist primarily in the U.K. and the Netherlands, and to a lesser extent in Ireland and Belgium. In these countries, there is wide opportunity for more such investments in the U.S. if certain U.S. market and regulatory conditions are altered.

There are, however, certain U.S. barriers to this investment which have not been fully dealt with under the various tax treaties, apart from the withholding tax on dividends and commercial real estate income, the situation has deteriorated significantly by the enactment in 1980 of the FIRPTA legislation with all its complications and ramifications. Especially difficult was the levy of capital gain tax on commercial real estate and direct venture capital investment, such as participation in oil and gas exploration and high technology companies.

As you know, FIRPTA provides that existing multinational tax treaties be preempted after January 1, 1985. Our pension funds were stunned to learn that this legislation would presume to override existing treaties, which it would not even be possible to renegotiate by January 1, 1985 by most of the countries represented in our organization. We are also shocked by the possibility that capital gains could be taxed retroactively. This we feel is unacceptable. It was helpful to the U.S. capital market, then in a depressed state, when investors from Europe acquired property in 1974/75. For the resulting gains to be taxed on the basis of the 1980 legislation even, it is rumoured, without a step-up in basis, is considered grossly unfair and not in keeping with what we would expect from the U.S. Congress.

This and the uncertainty surrounding the whole FIRPTA statute has, without any doubt, seriously dampened our investment interest in U.S. commercial real estate, oil and gas exploration and high technology, and will continue to deter such investment unless this law is repealed or very substantially modified to reignite our interest. Reading through the FIRPTA withholding requirements and the ramifications thereof, even going to the extent of having to calculate the actuarial interest of certain beneficiaries in a pension fund, is sufficient to deter any medium-sized pension fund from investing in the U.S. especially when the fund realizes that such legislation apparently can be clamped on retroactively. It also gives a strong incentive to a fund holding only a limited interest to dispose thereof.

In any event, overseas pension funds being tax exempt in their own countries balk at being subjected to tax when investing in the U.S. They point out that the U.S. itself recognizes their U.S. pension funds as eligible for tax exemption on exactly the same grounds as their own exemption at home, and U.S. pension funds investing in Europe are exempt from taxes there.

After the cold shower arising from FIRPTA at the end of the Carter Administration, the European pension funds considering further investments in the U.S. were greatly heartened by the introduction in Congress of various bills aimed at granting reciprocal tax exemption. Whatever the final provisions of any legislation to be forthcoming, it shows the idea that bonafide non-profit pension plans ought not to be encumbered by U.S. barriers in their investment in the capital markets of the world is recognized by the legislators of the U.S. where, by far, the most important of these markets is situated.

We hope you will act promptly to modify this law. Meanwhile, it will be clear that although a repeal of FIRPTA will by no means deal with all the various problems bonafide foreign corporate pension funds encounter as far as taxation with regard to

their U.S. investments is concerned, this will go some way toward alleviating these problems and will go a long way toward dealing with these problems as far as direct investments in commercial real estate, oil and gas exploration, and high technology are concerned.

It is emphasized that reducing barriers which prevent access to the U.S. capital market is a better way of encouraging such investments than maintaining high interest rates which, in the long run, will be both harmful to the U.S. economy and subject the U.S. to criticism in other parts of the world.

This view also seems to be underlined by the statement of Deputy Assistant Secretary Pearlman in his testimony before the House Ways and Means Committee on the first of May 1984 on H.R. 3025, a bill to repeal the 30 percent withholding on interest due overseas investors.

The Federation, therefore, strongly supports the initiative for the repeal of FIRPTA but would like to reiterate that it feels foreign non-profit corporate pension funds, in fact, ought to be exempt from all taxes on the same basis as U.S. corporate pension funds. I would ask to submit additional written views for the record of this hearing as an annex to my statement.

STATEMENT OF WAYNE HARMON, EXECUTIVE VICE PRESIDENT, LOUISIANA ASSOCIATION OF INDEPENDENT OIL PRODUCERS AND ROYALTY OWNERS

Mr. HARMON. Mr. Chairman, I am Wayne Harmon, the executive vice president of the Louisiana Association of Independent Oil Producers and Royalty Owners, which is headquartered in Baton Rouge, LA. I, too, will be very brief in consideration of the committee's time.

My purpose here today is to endorse the testimony which preceded me and as described—and which has described how much more difficult H.R. 1800 amending FIRPTA will make our task for raising capital for the independent oil and gas sector, which is very dependent upon that type of investment.

As our witnesses pointed out, oil and gas investments will be one of the major areas which will be affected by the FIRPTA rules.

For our member companies and my associations to be saddled with all the requirements set forth in H.R. 1800 amending FIRPTA is a staggering blow to an industry already faced with financial problems and anticipating the provisions affecting our industry and Treasury, too.

Domestic capital is tough enough to raise for our oil and gas exploration activity, but when your greatest hope is to have to find capital in Europe and your potential investors say, "We don't want to face withholding of excessive amounts of up to 10 percent of our capital," delays in refunds, affidavits which are beyond our control and other barriers, we get discouraged in a hurry.

I would ask, Mr. Chairman, that Congress examine the provisions of H.R. 1800 as it amends FIRPTA in the context of easing the technical as well as general inequities aggravating the capital shortage in our oil and gas industry.

To this statement, of which I will file a longer one with the permission of the Chair, I am asking that a recent resolution endorsing the modifications of FIRPTA adopted on March 21 by my executive board of directors, be included in the hearing record.

Mr. GIBBONS. We will be happy to include that.

Mr. HARMON. Thank you very much, Mr. Chairman.

[The resolution follows:]

RESOLUTION

The following signed and approved resolution states the policy of the **Louisiana Association Of Independent Producers and Royalty Owners** on the Foreign Investment In Real Property Tax Act (FIRPTA), Public Law 96-499, as amended.

WHEREAS, Congress enacted the Foreign Investment in Real Property Tax Act in 1980 with the intent that it apply solely to foreign ownership of American farmland but U.S. Treasury Department rules implementing the Act go far beyond the intent of Congress, and

WHEREAS, U. S. Treasury Department rules implementing FIRPTA exceed the original scope of FIRPTA by imposing a capital gains tax on foreign investment in U.S. oil and gas exploration and high technology firms, and

WHEREAS, foreign investment capital is essential to the continued health and strength of America's oil and gas exploration and high technology industries so vital for national defense, and

WHEREAS, all barriers to bona fide foreign investment capital should be removed to ease pressure on U.S. interest rates, and

WHEREAS, the governments of Great Britain, the Netherlands, France, West Germany, Belgium, and Luxembourg have formally protested that FIRPTA violates long standing tax treaties between their respective governments and the United States, and

WHEREAS, Congress is considering legislation to modify or repeal FIRPTA to encourage continued overseas investment capital being available to American oil and gas exploration and high technology industries,

WHEREAS, The original Congressional authors of the legislation are in favor of modification and/or repeal,

NOW, THEREFORE, BE IT RESOLVED:

That the **Louisiana Association of Independent Producers and Royalty Owners** does hereby support legislation to repeal and/or modify FIRPTA to no longer make it apply to foreign investment in American oil and gas exploration and high technology firms;

That Congress be petitioned to promptly enact such legislation to insure the continued availability of overseas investment capital, and

That a certified copy of this RESOLUTION be forwarded to Louisiana's U.S. Senators and the Louisiana House of Representatives Congressional Delegation.

Adopted this **21st** day of **March, 1985** by the **Board of Directors of The Louisiana Association of Independent Producers and Royalty Owners** at New Orleans, Louisiana, as certified by:

John J. Graham
President

C. Wayne Harmon
Executive Vice President

Donald W. Solanas
Secretary-Treasurer

Mr. GIBBONS. Mr. Maclean.

STATEMENT OF DANIEL C. MACLEAN, VICE PRESIDENT AND GENERAL COUNSEL, DREYFUS CORP., ACCOMPANIED BY WILLIAM MORRIS, WALTER POZEN, AND WILLIAM M. DALEY, COUNSELS

Mr. MACLEAN. Mr. Chairman, my name is Daniel C. Maclean. I am the vice president and general counsel of the Dreyfus Corp. located in New York City. I am appearing before this committee today on behalf of the Dreyfus Corp.

I am accompanied by our counsel on this matter, William Morris of the law firm of Rogers & Wells; Walter Pozen of the law firm of Stroock and Stroock & Lavan; and William M. Daley, of the law firm of Mayer, Brown & Platt.

We are here today to ask the committee to consider a technical amendment to section 904(d)(3) which was added by the Tax Reform Act of 1984.

I would like to thank the committee for the opportunity to make this presentation and request that I be able to summarize my presentation and that my prepared statement be printed in full in the record.

One of the leading authorities on corporate taxation, Prof. James Eustice, has noted in his book, "The Tax Reform Act of 1984" that taxpayers subject to section 904(d)(3) will face the burden of having to read, understand and apply its rules.

We have undertaken that burden, share Professor Eustice's view, and have concluded that technical modifications are absolutely necessary to section 904(d)(3).

Section 904(d)(3), added to the Internal Revenue Code by the Tax Reform Act of 1984, requires clarification.

We propose to clarify this provision with a technical amendment generally requiring that foreign source interest income received by a U.S. taxpayer through a financial intermediary retain its character as investment income. We are in the business of managing investment companies much like our foreign colleagues and I can express sympathy on a different problem.

As financial intermediaries, we provide the service of managing other people's money. We can often more efficiently manage assets than individuals can making investments directly.

The technical amendment proposed makes it clear that certain amounts of foreign source interest income received by a U.S. taxpayer through a financial intermediary, representing the investment of working capital in connection with the active conduct of a foreign trade or business, will not be treated as separate limitation interest income.

The legislative intent of section 904(d)(3) was to prevent the creation of a tax benefit where funds are invested through a financial intermediary. We submit that the intent of the Congress in achieving this end was not to create a tax detriment for investments made through a financial intermediary where the investments could be made directly without any tax detriment.

We believe the operation of section 904(d)(3) must be made clear and must not create any new benefit or detriment where an inter-

mediary is used. Accordingly, we suggest that the language of section 904(d)(3) (a) and (b) be amended to provide that dividends and interest paid or accrued by designated payor corporations be treated as interest income described in paragraph (2) without regard to subparagraphs (A) through (D).

This language provides more direct operation of the statute and makes clear that the exceptions of paragraph (d)(2) will not apply to the recharacterized dividends in the hands of the taxpayer.

In sum, the technical corrections suggested insure the implementation of the legislative intent of economic neutrality. The various forms of making investments directly or through an intermediary will thus not be driven by different tax consequences.

[The prepared statement follows:]

STATEMENT OF DANIEL C. MACLEAN, VICE PRESIDENT AND GENERAL COUNSEL, DREYFUS CORP.

SUMMARY

1. Section 904(d)(3), added to the Internal Revenue Code by the Tax Reform Act of 1984, requires clarification.

2. We propose to clarify this provision with a technical amendment generally requiring that foreign source interest income received by a U.S. taxpayer through a financial intermediary retain its character as interest income.

3. The technical amendment proposed also makes it clear that certain amounts of foreign source interest income received by a U.S. taxpayer through a financial intermediary, representing the investment of "working capital" in connection with the active conduct of a foreign trade or business, will not be treated as separate limitation interest income.

4. The legislative intent of Section 904(d)(3) was to prevent the creation of a tax benefit where funds are invested through a financial intermediary. We submit that the intent of the Congress in achieving this end was not to create a tax detriment for investments made through a financial intermediary where the investments could be made directly without any tax detriment.

STATEMENT

My name is Daniel C. Maclean. I am Vice-President and General Counsel of the Dreyfus Corporation located in New York City. I am appearing before this committee today on behalf of the Dreyfus Corporation. I am accompanied by our counsel on this matter, William Morris of the law firm of Rogers & Wells, Walter Pozen, of the law firm of Stroock & Stroock & Lavan and William M. Daley of the law firm of Mayer, Brown & Platt. We are here today to ask the committee to consider a technical amendment to section 904(d)(3) which was added by the Tax Reform Act of 1984.

This is a complex area requiring painstaking review and analysis. One of the leading authorities on corporate taxation, Professor James Eustice has noted in his book "The Tax Reform Act of 1984" that taxpayers subject to section 904(d)(3) will face the burden of having to read, understand and apply its rules. We have undertaken that burden, share Professor Eustice's view, and have concluded that technical modifications are absolutely necessary.

The amendment we propose would clarify the operation of Section 904(d)(3) and further the legislative intent of the section by precluding any new benefit or detriment through the use of a financial intermediary.

Prior to the Tax Reform Act of 1984, taxpayers could circumvent the general restrictions imposed on certain interest income earned abroad by causing foreign subsidiaries or regulated investment companies to earn interest income on their behalf and then distribute that income to them as dividends. Section 122 of the Tax Reform Act of 1984 added section 904(d)(3) to prevent U.S. taxpayers from converting separate limitation interest income to foreign source income for foreign tax credit computation purposes.

The precise operation of this new section is somewhat ambiguous. Section 904(d)(3) states that dividends or interest paid or accrued by a designated payor corporation "shall be treated as interest income described in paragraph (2)". Paragraph (2) states that the separate limitation will apply to all interest other than four categories listed in that paragraph.

One interpretation, literally reading the statute, is that dividends or interest paid or accrued by a designated payor corporation are to be treated as interest income described in paragraph (2) in the sense that such income is tested under paragraph (2) and interest or dividends not coming within one of the four exceptions is separate limitation interest.

The other possibility is that section 904(d)(3) deems any dividend or interest paid or accrued by a designated payor corporation to be separate limitation interest and not within one of the four exceptions of paragraph (2).

Either of these two interpretations seem to us to produce unintended and incongrous results.

The first interpretation calls for a testing under paragraph (2) of interest at the taxpayer level. This interpretation enables some taxpayers, through the use of an intermediary, to receive interest outside of the separate limitation which prior to the 1984 Act would have been treated as separate limitation interest. For example, suppose a 10 percent U.S. shareholder receives dividends from its foreign subsidiary. The foreign subsidiary makes loans to unrelated third parties. These loans are not made in a transaction directly related to the active conduct of a trade or business nor is the subsidiary in the banking business. Presume also that more than 10 percent of the subsidiary's earnings and profits are attributable to separate limitation interest. Under section 904(d)(3) the interest received by the subsidiary on these loans "shall be treated as interest income described in paragraph (2)". Under the first interpretation the dividends recharacterized as interest would be tested under section 904(d)(2) and would be excepted from separate limitation treatment under section 904(d)(2)(C) as received from a corporation in which the taxpayer owns at least 10 percent of the voting stock. This result does not comport with the general intent of section 904(d)(3) that the use of an intermediary should not result in tax consequences different than those consequences which would have resulted had the transaction been conducted directly.

The second interpretation, which would deem any dividend or interest paid or accrued by a designated payor corporation as subject to the separate interest limitation, also presents what we believe to be an unintended result. For example, suppose a taxpayer invests working capital (related to the active conduct by the taxpayer of a business in England) in a regulated investment company. The regulated investment company in turn makes loans to unrelated third parties. Under the second interpretation interest received by the regulated investment company is deemed to be interest treated as separate limitation interest. The exceptions listed in section 904(d)(2) are not applied. This result does not comport with the general intent of section 904(d)(3) in that the use of an intermediary should not result in tax consequences different than those consequences that would have resulted had a transaction been conducted directly. Specifically, had the taxpayer invested its working capital directly, the interest received would not have been separate limitation interest because it is excepted in section 904(d)(2)(A).

The operation of section 904(d)(3) must be made clear and must not create any new benefit or detriment where an intermediary is used. Accordingly, we suggest that the language of section 904(d)(3)(A) and (B) be amended to provide that dividends and interest paid or accrued by designated payor corporations be "deemed interest income to which paragraph (1) is applicable". This language provides more direct operation of the statute and makes clear that the exceptions of paragraph (d)(2) will not apply to the recharacterized dividends in the hands of the taxpayer. This will preclude the creation of any new benefit through the use of an intermediary. In addition, we suggest adding a new subparagraph (K) to section 904(d)(3) providing for a diminimis exception for taxpayers investing working capital and receiving only a small amount of separate limitation interest income. This language will preserve for taxpayers the ability available prior to the 1984 Act to invest working capital of an active trade or business in a foreign country through a financial intermediary. In sum, the technical corrections suggested insure the implementation of the legislative intent of economic neutrality. The various forms of making investments directly or through an intermediary will thus not be driven by different tax consequences.

Mr. GIBBONS. Let me make sure I understand what you are asking for.

Is the provision that is being inserted in the Technical Corrections Act acceptable to you or not acceptable to you?

Mr. MACLEAN. The proposed change that we are submitting would be acceptable to us.

Mr. GIBBONS. But there is nothing in it that takes care of your problem; is that correct?

Mr. MACLEAN. I don't believe the original draft of the bill included this language, so it did not correct our problem. Our problem is that we provide services as financial intermediaries. The 1984 act provided a de minimus exception for those corporations that choose to make investments directly through foreign subsidiaries.

We have a number of clients that chose to collectively invest with us. The bill as drafted made a distinction, incorrectly, we believe, in terms of intent of the law, between those persons acting directly and those persons who collectively invested through an investment company. Many of these entities are often less sophisticated or smaller companies. We believe whether you act directly or through an intermediary should not make a difference.

If there is a de minimus exception, you should be able to invest directly in certificates of deposits or indirectly by investing through our fund.

Mr. GIBBONS. Let me try to get parameters on the problem. Are there a lot of people involved in this?

Mr. MACLEAN. We really have two layers of involvement. There are investment companies that provide this service to a number of clients. There were at least four investment companies in the situation that I have described. They make investments in certificates of deposits and commercial paper or money market instruments that would qualify as foreign source income.

Each of those companies has clients. We have something in excess of 600 investors in our fund. I must tell you, a large number of them invest with us for other purposes. We believe the companies that have invested working capital in funds number somewhat over a hundred.

I would guess it runs into the hundreds in total in terms of taxpaying corporations that would be affected by the amendment as drafted.

Mr. GIBBONS. Is this the kind of problem that arises and when it does arise, the investment just won't be made and therefore the tax not paid?

Mr. MACLEAN. I think it is even worse than that to an extent. To the degree that what we are talking about facilitates foreign trade, and I start with the premise that foreign trade is desirable, the ability to invest your working capital is an important consideration in terms of an American company opening a sales office or operating a facility in a foreign country.

To the extent that you are a smaller corporation or a less sophisticated corporation that wants to rely on professional money managers to make investments, you may be deterred from doing what larger, more sophisticated corporations may do, because they have the organizational structure and people to make the kind of investments we do collectively.

Mr. GIBBONS. I think I understand.

Mr. Greenberg.

STATEMENT OF JACK GREENBERG, VICE PRESIDENT, TAXES, IU INTERNATIONAL CORP.

Mr. GREENBERG. Mr. Chairman and committee members.

I am Jack Greenberg, vice president, taxes, of IU International, a multinational corporation. I am here today to strongly object both procedurally and substantively to the provision in the Technical Corrections Act, section 101(a) of H.R. 1800 that changes the source of income rules for foreign tax credit purposes.

This provision is not a technical correction in that it specifically overrides longstanding congressional tax policy concerning 80–20 companies as it affects the foreign tax credit. It would also subject 80–20 companies to two sets of rules for foreign tax credit purposes, including two de minimis rules for the amount of U.S. source income the company could receive to avoid income resourcing.

Obviously this could place a severe and complex administrative burden on taxpayers; 80–20 companies are domestic coprorations which have more than 80 percent of their gross income from foreign sources. As long as less than 20 percent of the company's gross income is from U.S. sources, the company is considered as paying 100-percent foreign source income. Therefore, 80–20 companies are congressionally mandated de minimis safe harbor to facilitate foreign business transactions without having to formally incorporate foreign jurisdictions.

The 80–20 companies were not adversely affected by last year's substantive income sourcing change. IU uses an 80–20 as an integral part of foreign operations, and has done so for many years. The 80–20 company is essentially directly and indirectly engaged in business outside the United States, including substantial financing companies.

The 80–20 company in part raises funds from non-U.S. sources and then lends these funds throughout the IU group, which includes U.S. companies, on an as-needed basis. The income is an integral part of the overall financing cash flow and financial functions of the whole group. It is business income for business purposes, not manipulated income for merely source conversion purposes.

The income of the 80–20 company is subject to both foreign and U.S. taxation as well. Unless repealed by the Technical Correction Act provision I oppose today, the 80–20 company efficiently, practically and legitimately promotes and facilitates financial transactions and functions outside the United States permitting more readily repatriation to the United States of dividends, interest, and other income from foreign sources, along with the necessary utilization of foreign tax credits to avoid double taxation of the various incomes.

If enacted, the supposed technical correction discourages repatriation of income to the United States and leads to double taxation.

In summary, in specific reliance on express statutory provisions, IU has set up and long maintanied this 80–20 business and financing mechanism. It will now have to dismantle or completely restructure because of this supposed technical amendment. If Congress wants to reexamine 80–20 companies, it should do so as the

Treasury suggests in its tax reform package and not as a technical correction.

I believe strongly that 80–20 companies serve a useful purpose and must be retained. If not retained, there should be appropriate grandfather rules as part of any legislation. While there may be resourcing investment schemes that should be addressed as a part of technical corrections, IU's legitimate business operations must not be disrupted. If these perceived investment abuses need to be corrected, such legislation should be directed to similar and narrower remedies to the abuse rather than the proposed change for all 80–20 companies, including IU's.

We would be glad to work with your staff to ensure fair treatment to us while protecting the Treasury from ingenuous investment schemes.

[The prepared statement follows:]

STATEMENT OF JACK GREENBERG, VICE PRESIDENT, TAXES, IU INTERNATIONAL, PHILADELPHIA, PA

Under the Tax Reform Act of 1984 (Section 141 of the Act amending Section 904(g) of the Internal Revenue Code (Tax Code)), for foreign tax credit purposes, income payments by United States-owned foreign corporations were subjected to tracing to the income sources of the corporation, and such income payments were then resourced from foreign to United States source in proportion to the portion of the income of the corporation which was considered United States source. The income payments are not subject to resourcing if less than 10% of the corporation's earnings and profits for the taxable year are attributable to sources within the United States. The purpose of this change in the Tax Code was to prescribe artificial conversion of U.S. income to foreign income.

The above-described changes in the Tax Code did not apply to a domestic corporation which had more than 80% of its gross income from foreign sources (Section 861(a)(1)(B) of the Tax Code) and the income payments of which were considered as being 100% foreign source. This type of corporation is generally known as an 80–20 company which must have less than 20% of its total gross income over a 3-year period from United States sources. Under Section 110(a) of the proposed Technical Corrections Act of 1985 (TCA 85), the Tax Code would be amended to additionally subject an 80–20 company to the above-described tracing and resourcing rules for United States-owned foreign corporations, for foreign tax credit purposes.

In a corporate business group, an 80–20 company is a vehicle to permit and facilitate, under and in accordance with the Tax Code, foreign transactions/activities by a domestic corporation, which are the primary business transactions of such corporation. The corporation is thereby not forced to incorporate its business operations in a foreign country to conduct its business. The 80–20 company has been a part of the Tax Code for more than 20 years.

An 80–20 company pays 100% foreign source income for all purposes of the Tax Code, so long as it meets and continues to meet the 80–20 rules, which include a de minimus rule for U.S. source income allowed to be received by the 80–20 company (less than 20% of the corporation's gross income over a 3-year period). If there are perceived abuses of the 80–20 rules by investment plans promoted by the investment community or by artificial transactions, corrective legislation should be directed to simpler and narrower remedies for the abuse rather than the proposed change for all 80–20 companies, notwithstanding their bona fide business purposes. Furthermore, such legislation should not be proposed as being merely a technical correction. This clearly is a substantive, over-broad proposal to change a particular tax law passed by Congress, which has a long history and provides an effective, practical business operation in accordance with the Tax Code.

Where an 80–20 company is an integral, bona fide part of the finance and financial functions of a business group, the 100% foreign source treatment of its income payments should be continued for all purposes of the Tax Code, including foreign tax credit purposes. It conforms and is structured in accordance with the 80–20 provisions and objectives/intentions of the Tax Code as set by Congress, already is subject to and meets a specified U.S. source income de minimus rule, and has been part of the Tax Code for a considerable time without any "evil" being seen previously. There is no covert hiding or conversion of U.S. source income in an 80–20 company

which is an integral part of a business group. The de minimus rule for U.S. source income permitted to an 80–20 company is clearly seen, known, and required to be met with respect to a business 80–20 company. Correspondingly, the 100% foreign source treatment of income paid by such an 80–20 company has always been maintained for all purposes of the Tax Code, including foreign tax credit purposes, notwithstanding that an 80–20 company's income could include a de minimus amount of U.S. source income. Why should a business 80–20 company be subject to two sets of rules for foreign tax credit purposes, including the additional complexity and burden of tracing income sources, particularly as the second set of rules appears to be more of the same conceptual requirement with a business 80–20 company must essentially already meet in order to be an 80–20 company? The proposed "technical change" may really be objecting to the less than 20% threshold established by Congress as too high. The threshold is not too high, and any change is certainly not a "technical" amendment.

The de minimus degree of U.S. source income specified by Congress for an 80-20 company should not be a particular point of concern. For example, interest paid on a U.S. bank deposit to a foreigner is treated as foreign source income for all purposes of the Tax Code, notwithstanding that the bank's income may be 100% U.S. source. By comparison, an 80–20 company must have more than 80% foreign source income. It must meet the less than 20% de minimus rule for U.S. source income in order to be an 80–20 company. This is not the same case as where U.S. source income may be connected to foreign source income because such income is not effectively connected with a U.S. business of the foreign corporation, or because it is a part of an investment scheme or because of artificial transactions. A business 80–20 company is a bona fide business corporation engaged in bona fide business transactions, which are essentially foreign.

Within a corporate business group such as IU, an 80–20 company is essentially engaged, directly and through subsidiaries, in business outside of the United States, including substantial financing/financial functions. In connection with financing, the 80–20 company raises its funds from sources outside the United States rather than within the United States. Such funds are lent throughout the IU group of companies, which includes U.S. companies within the group, since such financing is done on an available, fungible group need basis. The income of the 80–20 company is effectively subject, directly and indirectly, to foreign taxation as well as to U.S. taxation. The income which it pays is an integral part of the overall financing, cash flow and financial functions of the IU business group; such income essentially funds debt service or other financial obligations to foreign lenders or obligees. It is business income, for business purposes; not manipulated-income for source conversion purpose. Although the 80–20 company receives income from U.S. affiliates as well as from foreign sources, as long as it meets the de minimus 80–20 rules of the Tax Code and engages in bona fide business operations, the long-recognized 100% foreign source treatment of income paid by an 80–20 company has efficiently, practicably and legitimately promoted and facilitated these financial transactions and functions outside the United States, including as part of such functions repatriation of dividends, interest and other income from foreign sources along with the necessary utilization of foreign tax credits to avoid double taxation of the various incomes from foreign sources.

Accordingly, we do not believe it is necessary to impose on an 80–20 company, a second set of rules, including another de minimus rule, and also adding substantial complexity/duplication and administrative burdens for foreign tax credit purposes. We fail to see or understand what is wrong or unreasonable with this long-standing congressional tax policy of an 80–20 company. The 80–20 company has always been subject to a de minimus rule for U.S. source income, which is not considered abusive to our knowledge, and such company has generally worked well within a business group. The current treatment of a business 80–20 company under the Tax Code should not be changed, particularly where concerned abuses apparently are seen in investment or other income conversion schemes of the investment community or in artificial transactions. Any changes should be directed to the perceived abuse. Changing the treatment of a business 80–20 company for foreign tax purposes will cause significant negative impacts on the foreign income flows to a business group such as IU, including the need to go through formal restructurings and refinancing to minimize such negative impacts, the possibility of greater exposure to double taxation occuring on repatriation of dividends, the reduction in foreign income repatriation, and the substantial increase in administrative costs of having to comply with complex income-tracing concepts in situations where concerned abuses should not practicably exist.

In summary, we believe that Section 110(a) should be eliminated from the TCA 85. It is far too broad and is inappropriate with respect to a business 80-20 company, for the reasons described above. Additionally, it proposes a substantive and burdensome change in the Tax Code. It is not a mere technical correction and should not be so treated. If a change in the Tax Code is to be considered here, it should be as a substantive legislative proposal (for example, as in the Treasury Department Report to the President, "Tax Reform for Fairness, Simplicity and Economic Growth," Volume 2, page 367). We, of course, disagree with the appropriateness of this proposal.

We are proposing changes for consideration of the staff which we believe will assure fair and continued treatment of business 80-20 companies while protecting the Treasury from investment schemes which are intended to only convert the source of income.

Mr. GIBBONS. I appreciate your sincerity and what you are trying to do, Mr. Greenberg, and I hope our staffs will work together on that.

I realize that this puts 80-20 companies in a severe bind. There may have been some discussion about putting them in a severe bind, but I frankly don't recall it. I try to pay particular attention to the interaction of our tax laws.

Let me ask some of these FIRPTA witnesses some questions.

How does FIRPTA affect investment decisions in Europe about investments in the United States?

Mr. Howard, you represent $6 billion worth of investments in the United States. How much is yours, yours is probably larger than that, is that correct?

Lord HOWARD. Mr. Chairman, the Association of Investment Trusts assets in total amount to about $20 billion.

Mr. GIBBONS. Twenty billion dollars.

Lord HOWARD. That is right. That is worldwide. Of that approximately $6 billion are invested in the United States.

Mr. GIBBONS. A little over a third of all your investments—less than a third?

Lord HOWARD. Just about a third, that is quite correct. The problem is that the uncertainty that has been created by FIRPTA, and this arises through the wide definition that FIRPTA now has ensnared companies. Just to give you two examples, which I have been personally connected with, there is a semiconductor company which was alarmed when we alerted it to FIRPTA and indeed they are a FIRPTA company. Even more ridiculous, there is a company called Bon Pan, your French I am sure is good, meaning good bread. That is a series of retail bakeries. That is a FIRPTA company.

Mr. Chairman, this has caused such worry among us investors that it begins to make us diffident about investing in U.S. companies for fear of being FIRPTArized.

Mr. GIBBONS. You say you have a third of all your investments in the world here in the United States and that is about $6 billion. FIRPTA has caused so much uncertainty—are you seriously considering backing out of some of your investments?

Lord HOWARD. What I think is probably the correct description, Mr. Chairman, to indicate our apprehension is that new money coming over here to be invested particularly as we heard from Mr. Wayne Harmon in such cases as oil and gas, this is going to be severely prejudiced and subjected to a 28-percent tax on FIRPTA

makes that investment very, very difficult to stack up against alternative investment, say oil and gas in Australia.

Mr. GIBBONS. Well, the 10-percent withholding is bad enough but it looks like to me that 28-percent withholding on your gaining is almost impossible for a purchaser to figure. I don't know how a purchaser can figure the 28-percent withholding. I try to be a practical man and I have had to close some transactions in my life and be responsible for disbursement of those transactions and they can take enough hair off your head to become bald as a cueball, but when I as a transaction closer have got to withhold 28 percent of the seller's gain, I don't know how in the world I could ever figure that one.

Lord HOWARD. With the transfer agent or the person who is buying the FIRPTA company, what he is obliged to do is to withhold 10 percent of the gross proceeds.

Mr. GIBBONS. But they are suggesting 28 percent.

Lord HOWARD. And that is a withholding measure subject to final quantification of the liability, which is 28 percent of the gain. It is quite possible that some of our investments make no gains at all, and therefore we are deeply concerned that 10 percent may be withheld, but in fact the transaction to the investor is being sold as a loss.

Mr. GIBBONS. As I understand it, they proposed to cure that 10 percent by substituting in effect the 28-percent withholding on the gain. What worries me is how in the world is somebody closing a transaction like that ever going to figure out what the seller's gain is until the seller——

Lord HOWARD. Mr. Chairman, your anxieties are the same as mine.

Mr. GIBBONS. That is not something that you can figure out at a closing of a transaction in most cases that I have ever been through.

Lord HOWARD. I think the problem is exacerbated through the extension of FIRPTA.

Mr. GIBBONS. What companies in the United States are impacted most frequently by your investments?

Lord HOWARD. It is mostly, Mr. Chairman, in the oil and gas companies. Because of the definition of what is a U.S. real property owned company, it can be high technology companies and venture capital companies. Those are the three areas with which we are most concerned.

Mr. GIBBONS. In Europe what is going on about the treatment of reciprocal investments by citizens of the United States in European countries? I often go to these meetings with you chaps and I know there is a tendency to—I shouldn't say retaliate, but respond in kind to this kind of treatment. Is that going on in Europe now?

Lord HOWARD. Can I ask my colleague to answer that?

Mr. VAN TETS. I can only speak for the pension funds and as far as they are concerned, as I mentioned in Holland, the U.S. pension fund which is recognized as the fund of this country would not be taxed on its real estate investments and I have heard of no intention to change it because of what has been going on here so far

In a country like Germany, there a foreign investor might be subject to tax, but might avoid that to a large extent by financing it through a loan arrangement.

In that case, the German Government might look at whether there was a question of thin capitalization. However, if they know it is a pension fund they tend not to raise that issue and agree that such a fund, the equivalence being tax exempt in their own country, should not in fact suffer tax.

Mr. GIBBONS. Doesn't FIRPTA to some extent amount to a unilateral renunciation of a treaty that we have? We have treaties with most European countries on tax matters.

Mr. VAN TETS. That, Mr. Chairman, is one of my main points in this technical connection, that in fact after so many years without the treaties being renegotiated on the first of January last, the law here, the FIRPTA law preempted existing treaties and overrode them, and that is something we would like lifted in this technical correction bill.

A letter has been written on behalf of six European governments together on this matter and I find that they have used pretty strong language for a letter through the diplomatic mail between allies when they say that they emphasize the urgency of their concern, that they think some of the provisions are onerous and unfair, that it calls into question the whole purpose of having the treaties and that they think some of the provisions are unreasonable.

I think that is fairly strong language when you object to something one of your major allies is doing. The European resolution raised it this way, that they are concerned at the tendency of the U.S. administration in some cases to extend the fiscal measures beyond the scope of its jurisdiction. That in fact refers to the same point.

Mr. GIBBONS. Mr. Anthony.

Mr. ANTHONY. Thank you, Mr. Chairman.

First, I would like to go on record in support of the previous statement that you made about your original objection. I am keenly aware of the fact that you do participate in oil and gas ventures and believe this to be highly desirable. Due to the various constraints now placed on oil exploration and the possibility of eliminating various tax benefits in a tax reform package, your investments are particularly important.

You did not mention in your definition of commercial real estate transactions whether or not you were engaged or looking at the purchase of timber lands in the United States.

I would like to have your comment on that.

Lord HOWARD. Can I answer that as regards the Association of Investment Trust Companies? Our members have very little investment in real estate as commonly defined, namely, commercial property and agricultural property and timber land. Our disappointment with FIRPTA is that it has extended beyond that, the original intention of Senator Wallop.

Mr. VAN TETS. As far as the pension funds are concerned, Mr. Chairman, they also do not have to any significant extent if at all farm land or timber land. Their main interest is in commercial

real estate, office buildings and shopping centers, warehousing and potentially in some minor cases the venture capital field.

Mr. ANTHONY. If the law were straightened out, do you think that there is a sufficent area of interest in timber land, enough where you might be willing to take a look at it in the long run?

Lord HOWARD. It would greatly certainly assist us if the definition was changed and just therefore applied to properties as the layman normally construes it.

Mr. ANTHONY. There is a very real economic reason for asking this question. There are about 8 million acres of timber land on the market in the South, and obviously with this type of surplus there is a terrible market climate. The whole industry is really in a depressed condition, and if the law could be straightened out to the extent that it would make sense for the pension funds to go into those type of investments, it would be very beneficial. It could be an extremely good investment, since there is such a large surplus. In fact, it looks like there will be more timber land coming on the market, rather than less.

Mr. VAN TETS. It is always a question of the alternative merit of investment and timber lands would not be excluded. Would it apply only to farm land or would it be the alternative investment once again for the possibility?

Mr. ANTHONY. I represent a farming area. I know there was a fear that foreign investors were going to come in and own all our farm land. I think those farmers are not as concerned today as they once were. I think they would welcome foreign investors coming in and helping shore up the price of the land because many are in bankruptcy and can only find one buyer and that is the Federal Government.

The Federal Government is not inclined to pay a very high price.

Mr. Chairman, I support trying to find a simple way to work our way out of this.

Mr. FORD [presiding]. Any further questions by members for this panel? If not, we thank the panel for testifying before the committee.

At this time, the committee will call the next panel: Mr. Uslander, Mr. Golden, and Ms. O'Connell.

The committee will recognize Mr. Uslander.

STATEMENT OF GERALD L. USLANDER, PRINCIPAL, WILLIAM M. MERCER-MEIDINGER, INC.

Mr. USLANDER. Thank you.

I am an attorney and a principal of William M. Mercer-Meidinger, Inc. Mercer-Meidinger is the world's largest consulting firm in the field of employee benefits, compensation, and communications. We provide consulting advice to more than 10,000 clients in every category of business, industry, Government, and nonprofit organizations.

I commend your quick response and your efforts to provide needed technical clarification to the Tax Reform Act of 1984 and the Retirement Equity Act.

I also echo your concern that the two technical corrections bills that we are dealing with today should not make substantive and nontechnical changes to either of these laws.

DEFRA and REA were two pieces of major legislation affecting employee benefits and they were both passed in the same year.

I am sure you can imagine the reaction of employers to having to make wholesale changes in their benefit plans to comply with DEFRA and, shortly thereafter, REA; and both following so soon after TEFRA. So it is essential that H.R. 1800 and 2110 confine themselves to purely technical clarifications so that employers will not be required to make additional substantive changes at this time.

Hopefully any substantive changes would be dealt with only after extensive deliberations by Congress and then giving employers a substantial amount of advance notice before these new changes would become effective.

In H.R. 1800, the technical corrections legislation on DEFRA, I only have one observation, and that is in the area of funded welfare benefit plans and the proposed definition of what is not a fund.

As you know, if a welfare benefit fund is not a fund under the law, then the new reserve restrictions don't apply.

It seems that the new definition proposed in the bill adds to the confusion in the area of which insurance contracts are and are not funds.

I spoke to a number of professionals in my firm that deal with welfare benefits and none of them could recognize exactly what is being described in that situation. The general feeling is that what you are trying to do is say that a truly experience rated insurance contract is a fund and anything that is not truly experience rated, whatever that might mean, is not a fund. I would hope that somehow the language can be tightened up so that we have a better understanding of what it is that it is trying to describe.

In the area of corrections to the Retirement Equity Act, I will mention one or two of them. The rest are in my prepared statement, which I request becomes part of the hearing record.

One of the problems is in the area of what is the earliest retirement age. Internal Revenue Code section 417 defines "earliest retirement age" as the earliest date on which, under the plan, the participant could elect to receive retirement benefits.

Section 417 says that if a participant dies before having attained that earliest retirement age, the surviving spouse is entitled to a survivor annuity which doesn't have to begin earlier than the month when the deceased participant "would have attained the earliest retirement age under the plan."

If a participant dies before achieving the service necessary under the plan for early retirement, and is survived by a spouse, would the spouse receive the annuity at the time the participant would have attained the earliest retirement age had he or she lived, on the theory that he or she would have continued to earn service? Or would the spouse have to wait until the participant would have reached age 65, because once you die, you can't achieve any more service.

There is a difference of opinion among Treasury spokesmen that answer questions publicly and this is something that needs to be cleared up in the bill.

One other area involves spouse consent to lump-sum distributions from a profit-sharing plan that does not have to comply with the joint survivor annuity requirements. There is again a Treasury spokesman who is saying that you cannot distribute a deceased participant's account balance in an immediate lump sum to a surviving spouse from a profit-sharing plan without spouse consent. There is nothing in the law currently that requires spouse consent to a lump sum from a plan that does not have to comply with the joint and survivor annuity requirements. If it is Congress' intent that spouse consent apply to a plan to which the joint survivor annuity requirement do not apply, then I think that should be clarified. Time does not permit me to raise other points, but they are in my prepared statement for your study and review.

I will finish with a plea that you impress upon the Treasury Department the urgency that they move forward with formal guidance in areas that do not need clarification by legislation. With so many laws having been passed in rapid succession, we need guidance to know how to administer plans. If Congress would only try to impress upon Treasury the need for prompt action, I think employers would not feel that they have the administrative problems that they do.

Thank you, Mr. Chairman.

Mr. FORD. Thank you.

[The prepared statement follows:]

STATEMENT OF GERALD L. USLANDER, PRINCIPAL, WILLIAM M. MERCER-MEIDINGER, INC.

My name is Gerald L. Uslander. I am an Attorney and a Principal of William M. Mercer-Meidinger, Incorporated. Mercer-Meidinger is the world's largest consulting firm in the field of employee benefits, compensation and communications. Mercer-Meidinger provides consulting advice to more than 10,000 clients in every category of business, industry, government and non-profit organizations. Our clients range in size from the smallest employers to the largest corporations in the world. Because of the broad based nature of our clients, I bring to you a wide range of needs for clarification.

I commend your quick response and your effort to provide needed clarifications to DEFRA and REA. However, H.R. 1800 and H.R. 2110 would make substantive and nontechnical changes to the laws in addition to merely technical clarifications. DEFRA and REA were two pieces of major legislation affecting employee benefits passed in the same year. You can imagine the reaction of employers to having to make wholesale changes to their plans to comply with DEFRA and then shortly thereafter REA, and both falling so soon after TEFRA. I believe it is essential that H.R. 1800 and H.R. 2110 confine themselves to purely technical clarifications so that employers will not be required to make additional substantive changes at this time.

I would hope that any substantive changes in the law would only be made after extensive deliberations by Congress and that any such changes will give employers a substantial amount of advance notice before they become effective.

With one exception, my remarks today will concentrate on the technical corrections to the Retirement Equity Act being proposed in H.R. 2110. I only have one observation concerning H.R. 1800.

DEFRA imposed funding limitations on funded welfare benefit funds in order to prevent what Congress deemed excessive deductions by employers making contributions into these funds. It is true that DEFRA, as written, has caused confusion in the area of insurance contracts as to what is or is not a fund. If the vehicle is determined not to be a fund, the funding restrictions will not apply.

Section 151(a)(8) of H.R. 1800 attempts to clarify the definition of welfare benefit fund. However, the clarification only adds to the confusion. It is difficult to deter-

mine exactly what kind of an arrangement, which would not be a fund, is being described in the new proposed provision. I have conferred with a number of professionals in my firm who deal exclusively in the area of welfare benefits, and they have been unable to recognize exactly what is being described. Our general feeling is that what the change is attempting to make clear is that a "truly experience rated" insurance contract will be considered a fund and anything else will not be considered a fund. I would hope that the language of the change can be tightened up to make this, or the actual intent, more apparent. I would also hope that the committee report will fully explain the significance of this provision.

I have a number of observations concerning H.R. 2110:

1. There is widespread disagreement, even among various Treasury Department spokesmen, regarding the definition of Earliest Retirement Age. IRC 417(f)(3) defines Earliest Retirement Age as the "earliest date on which, under the plan, the participant could elect to receive retirement benefits." IRC 417(c) says that if a participant dies before having attained the earliest retirement age, the surviving spouse will be entitled to a pre-retirement survivor annuity which need not begin earlier than the month in which the participant "would have attained the earliest retirement age under the plan."

In the case of a vested participant or former participant who dies before satisfying the requirements for the early retirement age, when is the earliest time at which the surviving spouse can elect to receive the annuity? For instance, if a plan has an early retirement age of 55 with 15 years of service, and a normal retirement age of 65, and if a participant dies at the age of 50 with 10 years of service, may the spouse begin to receive the annuity when the participant would have reached age 55 with 15 years of service, had he lived, or only at the date the participant would have reached age 65, which is the latest date that commencement of the annuity can be postponed without spouse consent? In other words, is the intent of the law that it be assumed that the participant would have satisfied the service requirement had he continued to live?

Many steel plans allow retirement with 30 years of service. The same question would apply if a participant in a steel plan died before being credited with 30 years of service. Would the participant's surviving spouse be entitled to the pre-retirement survivor annuity at the time the participant would have had 30 years of service or would the spouse have to wait until normal retirement age? As I said, various Treasury Department spokesmen have given different answers. The provision should be clarified one way or the other. My recommendation is that the law be made clear that service would have continued after death.

2. There are several issues relating to spouse consent that need clarification. IRC 401(a)(11)(B)(iii) states that a profit sharing or stock bonus plan does not have to comply with the qualified joint and survivor annuity and pre-retirement survivor annuity requirements if certain conditions are met. One of these conditions is that the plan provide that the participant's accrued benefit "is payable in full, on the death of the participant, to the participant's surviving spouse . . ." or to another beneficiary only with spouse consent. It seems clear from the wording of this provision that if the conditions for nonapplicability of the joint and survivor annuity requirements are met, and the plan provides that the participant's benefit will be paid to the spouse, no spouse consent to that payment in a lump sum should be required.

In spite of this, a Treasury spokesman said that, unless the spouse consents, at least one-half of the participant's account balance has to be paid in the form of a life annuity. The only provision of the Internal Revenue Code that provides for spouse consent to a lump sum distribution is in IRC 417(e)(2). However, IRC 417 only applies to a plan which must meet the requirements of IRC 401(a)(11). In the case of a profit sharing plan which does not have to meet the requirements of IRC 401(a)(11), IRC 417(e)(2) does not apply and should not be made applicable.

This point should be clarified either in IRC 401(a)(11) or IRC 417. If it is intended that the distribution to the spouse should be subject to the general cashout rules in IRC 411(a)(11), that provision should be rewritten because it now only provides for consent of the participant and not the participant's spouse to a cashout over $3500.

Section 2(b)(4) of H.R. 2110 amends IRC 417 to provide that no portion of a participant's accrued benefit may be used as security for a loan without spouse consent. It is my understanding that Committee staff intends that this spouse consent provision should apply to all plans, whether or not they must comply with the joint and survivor annuity requirements of the law. Since the amendment requiring spouse consent to loans is in IRC 417, which section only applies to plans which must comply with the joint and survivor annuity requirements, I do not believe that the objective of applying the spouse consent requirement to all plans has been met.

I suggest that there be a clarification that the requirement does not apply to plans which need not comply with the joint and survivor annuity requirements. If your intention is that it does apply, the new spouse consent requirement should be placed in another section of the Internal Revenue Code.

Section 2(b)(6) of H.R. 2110 also amends IRC 417 to provide for informed consent, whereby the spouse, in consenting to the waiver of the joint and survivor annuity, must also consent to the beneficiary designated in the waiver and to each subsequent beneficiary change. While it is clear that the spouse must consent to beneficiary changes, it is not clear whether the spouse must consent to a change in the form of payment. For example, if the spouse consents to the children being named as the beneficiary of a form of payment, can the participant then change the form of payment and take a lump sum without naming a different beneficiary, and without spouse consent? This point should be clarified.

3. There are a number of issues relating to cashout of benefits which create problems. The threshold for determining whether there may be a unilateral cashout or whether there may be a cashout only with the consent of the participant (and his spouse where applicable) is a present value equal to $3500. The law is clear that the present value will be calculated using an interest rate not greater than the rate used by the Pension Benefit Guaranty Corporation for purposes of determining the present value of a lump sum distribution on plan termination. An open question is whether this same PBGC rate must be used to determine the amount of the benefit to be cashed out.

The law should be clarified to state that the PBGC rate will be used to determine the threshold, but the rate stated in the plan for calculating a lump sum distribution will be used to determine the amount of the benefit. If it is permissible for the rate in the plan to be used for other purposes, I see no reason why it should not be used in this case.

As an alternative, perhaps the PBGC rate could be used to determine the amount of the benefit if it is a cashout under $3500, while the plan rate could be used to determine the amount of the benefit if it is more than $3500. The rationale for this would be that the participant would have to consent to the cashout if it is more than $3500, so the participant can control the rate to be used.

Another open question concerns the fact that there is apparently not a single PBGC rate. There are alternative rates, such as the PBGC immediate rate or the single PBGC rate structure. Various IRS spokesmen have given various answers as to whether the immediate rate or the entire rate structure is to be used. I have no recommendation as to which approach should be adopted, but recommend that one or the other be adopted in order to clarify the situation.

The law should be clarified as to whether the cashout rules apply only to the employer funded accrued benefit, or also apply to employee contributions. I believe that the cashout rules do apply to employee contributions, and in determining whether the threshold has been met, both employer contributions and employee contributions are taken into consideration. However, there is disagreement on this point and clarifying guidance is needed. In addition, the guidance should state whether qualified deductible employee contributions are also to be considered.

A related issue is whether the cashout rules apply to the entire accrued benefit or only to the vested portion. In other words, must the vested accrued benefit be $3500 or more to have met the threshold or must only the entire accrued benefit, whether or not fully vested, be $3500 or more?

H.R. 2110 amends IRC 414(p) to prohibit the cashout of a benefit due a payee under a qualified domestic relations order, even if the payee/spouse consents, prior to the participant's termination of employment, if the amount of the payment due exceeds $3500. This provision seems to apply to any plan. It should not apply to defined contribution plans. The effect of this would be to require periodic payments from defined contribution plans and to prohibit lump sum distributions even if the payee consents. This is not consistent with the purposes of the qualified domestic relation order provisions, which are to protect the rights of the divorced spouse and to simplify the administration.

In addition to preventing a cashout even with spouse consent, including the restriction in defined contribution plans could cause other administrative problems. For instance, if the plan allows participants to direct investments among various investment funds, wouldn't this right also have to be given to a QDRO payee whose benefit could not be distributed because it is over $3500? It seems that the answer could be in the affirmative and this would unduly complicate plan administration.

4. IRC 401(a)(11)(B)(iii)(I) says that, in order to avoid compliance with the joint and survivor annuity requirements, a defined contribution plan that provides for a death benefit to someone other than the spouse, must provide that the spouse con-

sents to the non-spouse beneficiary in the manner required under IRC 417(a)(2)(A). This latter section only covers the fact that the consent must be in writing and witnessed. It does not deal with the requirement to give notice nor does it deal with the time frames of giving notice and making the election. I suggest that IRC 401(a)(11) be clarified so that the reference is to those sections of IRC 417 that cover the notice requirement and the timing requirements, or else special notice and timing requirements be provided.

5. I suggest that the law be clarified as to whether a spouse's waiver of the joint and survivor annuity constitutes a gift that is taxable for gift tax purposes. This problem arises because H.R. 1800 repeals IRC 2517. IRC 2517 provides that the exercise or non-exercise of an election or option under a qualified plan is not considered a transfer for gift tax purposes. If this section is repealed, the question arises whether spouse consent would be a taxable transfer.

There are many other areas that could be discussed as needing clarification in both H.R. 1800 and H.R. 2110. However, it would not be possible to include all of them in my presentation.

I urge you to impress upon the Treasury Department the urgency of moving promptly to issue formal guidance on the various changes made by DEFRA and REA. Many questions have been asked of Treasury by practitioners, so they are well aware of areas that need clarification and guidance. With so many recent laws having been passed that affect benefits in varying ways, employers must have immediate guidance on how to proceed with the administration of their various benefit programs.

I want to thank you for your indulgence and for giving me the opportunity to assist you in discussing needed clarifications to DEFRA and REA. Both I and my firm are at your and your staffs' total disposal in proceding with your work. We stand ready to assist you in any way we can and would welcome your calling upon us.

[The following was subsequently received:]

WILLIAM M. MERCER-MEIDINGER, INC.,
Louisville, KY, May 21, 1985.

Mr. JOSEPH K. DOWLEY,
Chief Counsel, Committee on Ways and Means, House of Representatives, Washington, DC.

DEAR MR. DOWLEY: In addition to my testimony given at the May 16 hearing on technical corrections to DEFRA and REA, I am submitting the following for an additional clarification to REA.

I suggest that REA be clarified to more fully explain what is a fully subsidized qualified joint and survivor annuity within the meaning of IRC § 417(a)(4), added by § 203 of REA.

Specifically, an IRS spokesman has said that about the only way to have a fully-subsidized QJ&S option upon retirement is for the QJ&S to be the only form of payment. Even if the QJ&S benefit is provided unreduced to married participants, this will not be considered fully subsidized if the participant could have elected another form of payment (e.g. life only or lump sum) and receive more in benefits prior to a premature death of the participant and spouse. Thus, in most cases, the QJ&S notices will be required even in plans which provide the QJ&S benefit to married participants on an unreduced basis.

I believe that this is too narrow of an interpretation of the law that would render it virtually meaningless. It seems to me that the IRS would be making a substantive law change by adopting this approach.

Very truly yours,

GERALD L. USLANDER, *Principal.*

Mr. FORD. Mr. Golden.

STATEMENT OF HOWARD J. GOLDEN, CHAIRMAN, RETIREMENT SAVINGS/ERISA-TAX COMMITTEE, ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS, AND VICE PRESIDENT, TOWERS, PERRIN, FORSTER & CROSBY

Mr. GOLDEN. Mr. Chairman and members of the committee, I am Howard J. Golden, vice president of Towers, Perrin, Forster & Crosby, international consultants to management, and I am here

today representing the Association of Private Pension and Welfare Plans, the APPWP. The association is a nonprofit organization, founded in 1967 to foster the growth of this country's employer-sponsored group employee benefits system. We represent over 475 organizations throughout the United States.

We welcome the opportunity to testify before the committee on H.R. 1800 and H.R. 2110. While we believe that many of the provisions of these bills represent an appropriate clarification of the Tax Reform Act of 1984 and the Retirement Equity Act of 1984, it appears that in certain respects, the bills would make substantive and nontechnical changes in the Code.

Recognizing that the line between technical and substantive changes is not always clear, we nonetheless urge the committee to avoid yet another annual set of substantive changes in the laws governing employee benefit plans without a full congressional consideration of their ramifications.

I will be brief and my extended remarks will be included in the record.

Our concerns with the technical corrections bill fall in three general categories.

One, the committee and Congress should closely analyze whether any technical corrections should be retroactive.

Point two, there are a number of important areas requiring technical correction that have been totally ignored by these bills.

Point three, there are issues which, while treated in the bills, remain vague and confusing.

I will now illustrate each of these points briefly in the time remaining to me.

One, certain of the retroactive effective dates in both bills cause confusion and if enacted unchanged will create hardship on plans or participants.

For example, in H.R. 2110, the amendments to the qualified domestic relations orders provision in code section 414(p) have apparently retroactive effective dates which would result in the inadvertent disqualification of a plan that had already taken action. A similar effect could be read to result from the retroactive effective dates in H.R. 1800 in the sections amending the welfare benefit fund and unrelated business income rules.

Point two, there are a variety of different issues under the Retirement Equity Act which have not been clarified in H.R. 2110. The entire area of in-service withdrawals is not fully addressed by the bill and left unresolved are a number of practical concerns relating to pension plans which are required to provide spousal annuities, and to profit sharing and stock bonus plans which meet the exception in code section 401(a)(11)(B).

Congress should clarify that spousal consent, as suggested in the Technical Corrections Act, is not required for in-service withdrawals or loans from plans that meet the code section 401(a)(11) exception.

Similarly, H.R. 2110 does not deal with the confusion that has arisen from code section 417(e) which prohibits the mandatory cash-out of lump-sum benefits, the present value of which exceeds $3,500. Although the statute makes clear that a rate no greater than the Pension Benefit Guaranty Corporation's rate for deter-

mining the value of a lump-sum distribution on plan termination must be used, it is not clear when that rate is to be used and there are differing opinions from Treasury personnel on this matter.

An additional area omitted from H.R. 2110 relates to the application of the anticutback rule to terminated plans. There is confusion and no guidance with respect to the obligations of an insurer that issues irrevocable commitments to participants in a terminating plan as a result of the amendment of section 411(d)(6) by section 301 of REA.

The technical corrections bills themselves create confusion, and I can only give one example in the time remaining to me. The change in H.R. 2110 which prohibits the cashout of a divorced spouse's benefit in excess of $3,500 is in our view ill-considered and does not reflect in our opinion the previous legislative history or the current Treasury interpretation.

There are a number of other vague provisions in the technical corrections bill which, in our view, could be reworked. We would be happy to work with the committee staff in exploring additional areas of concern other than the many detailed ones outlined in my statement and providing other technical assistance.

Mr. Chairman, I thank you for the opportunity to testify today.

Mr. GUARINI [presiding]. Thank you.

[The prepared statement follows:]

STATEMENT OF HOWARD J. GOLDEN, ON BEHALF OF THE ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS

Mr. Chairman, and members of the committee, I am Howard J. Golden, Vice-President of Towers, Perrin, Forster & Crosby, international consultants to management, and I am here today representing the Association of Private Pension and Welfare Plans ("the APPWP"). The Association is a nonprofit organization, founded in 1967 to foster the growth of this country's employer-sponsored group employee benefits system. We represent over 475 organizations throughout the United States: both large and small employers who sponsor plans, as well as the leading support organizations to private plans, including banks, insurance companies, and accounting, actuarial and consulting firms. Collectively, the APPWP's membership is involved directly with virtually all employee benefit plans.

We welcome the opportunity to testify before the Committee on H.R. 1800 and H.R. 2110. While we believe that many of the provisions of these bills represent an appropriate clarification of the Tax Reform Act of 1984 ("DEFRA") and the Retirement Equity Act of 1984 ("REA"), it appears that in certain respects, the bills would make substantive and nontechnical changes in the Code. Recognizing that the line between technical and substantive changes is not always clear, we nonetheless urge the Committee to avoid yet another annual set of substantive changes in the laws governing employee benefit plans without a full Congressional consideration of their ramifications.

Thus, in the Association's view, it is important that the Congress deal fully with the questions raised by REA and DEFRA, rather than leaving many of the difficult issues unaired before the tax-writing committees. Pension plan sponsors and service providers are often subject to vaguely drafted new Code provisions long before any consistent and widely available guidance is available from the Treasury. Not only are the rules of the game changing frequently; it is nearly impossible to administer employee benefit plans with regulatory guidance lagging months or even years after the effective date of legislative changes. We recognize the difficulties inherent in rapid issuance of regulations; however, these bills present the Congress with the opportunity to make necessary clarification in the law with public input and full consideration of all of the competing concerns raised by these issues. Difficult technical issues should not be left to the Treasury, particularly in light of this opportunity to clarify the laws now.

Our concerns with the technical corrections bills fall into three categories. First, Congress should closely analyze whether any technical corrections should be retroactive. Second, there are a number of important areas which have been totally ig-

nored by H.R. 1800 and 2110. Finally, there are issues which, while treated in the bills, remain vague and confusing.

Certain of the retroactive effective dates in both H.R. 1800 and H.R. 2110 cause enormous confusion, and if enacted unchanged, will create hardship on plans and participants. For example, in H.R. 2110, the amendments to the qualified domestic relations orders provision in Code Section 414(p) have retroactive effective dates which would result in the inadvertent disqualification of a plan because of conduct taken in good faith on the basis of a hazily drafted section of the law. A similar effect would result from the retroactive effective dates in H.R. 1800 in the sections amending the welfare benefit fund and unrelated business income rules.

Our second area of concern is the variety of difficult issues under the Retirement Equity Act which have not been clarified in H.R. 2110. The entire area of in-service withdrawals is not fully addressed by the bill. Left unresolved are a variety of practical concerns, relating both to pension plans, which are required to provide spousal annuities, and to profit sharing and stock bonus plans which meet the exception in Code section 401(a)(11)(B)(iii). Administrators have no clear guidance as to whether spousal consent is necessary only where the combined value of vested employer and employee contributions exceeds $3500, or instead, whether consent is required only where the vested account balance derived only from employer contributions exceeds that threshold. In addition, Congress should clarify that spousal consent is not required for in-service withdrawals or loans from plans that meet the Code section 401(a)(11) exception.

Similarly, H.R. 2110 does not deal with the confusion that has arisen from Code section 417(e), which prohibits the mandatory cash-out of lump sum benefits, the present value of which exceeds $3500. Although the statute makes clear that a rate no greater than the Pension Benefit Guaranty Corporation's rate for determining the value of a lump sum distribution on plan termination must be used, it is not clear when that rate is to be used. The statutory language of REA gives rise to the view that the PBGC rate is to be used only to determine whether the threshold of $3500 is met, and not for the actual valuation of the cash-out, which is properly calculated using plan rates and factors adopted pursuant to Code section 401(a)(25). Informally, however, the Treasury takes a contrary view, mandating the use of PBGC rates for all purposes. This lack of clarity may create liability for plan sponsors.

An additional area omitted from H.R. 2110 relates to the application of the anti-cutback rule to terminated plans. The statute offers no guidance with respect to the obligations of an insurer that issues irrevocable commitments to participants in a terminating plan in accordance with the requirements of Title IV of ERISA. Nor has Treasury guidance been forthcoming.

After REA's amendments to Code section 411(d)(6), insurers have no certainty with respect to the value of the benefits to be provided after plan termination, since a participant who meets the conditions of a benefit subsidy after plan termination must be provided that subsidy. The insurer will inevitably be obligated to price the annuity as if all conditions will subsequently be met. Such a course could conceivably deplete plan assets which might otherwise be applied to other lower priority benefits under the plan. Indeed, that assumption could cause an otherwise sufficient plan under Title IV to become insufficient and therefore trusteed by the PBGC, rather than closed out in the private sector. In addition, this rule requires that the plan sponsor continue to keep records of service for participants who have not satisfied the conditions for the subsidy, as if the plan had been terminated. Some insurers, in order to protect themselves, have even insisted that subsidies be provided even where service conditions could not possibly be met, as where the employer ceases operations and no further service could be earned.

The confusion and disruption that has been created in this area is strong. In light of the fact that there has been no demonstration that plan sponsors have terminated their plans in order to diminish the benefit rights of participants, we think there should be a thorough reconsideration of the need to extend the REA rules beyond plan termination.

REA itself, as well as the proposed amendments in H.R. 2110, create a difficult administrative burden on plan administrators, especially those responsible for individual account plans. Separated participants with small account balances ($3500 or more) can insist on deferring distribution beyond their termination of service, creating detailed accounting requirements for plan administrators as they attempt to account for twice or three times the number of individual accounts, and supply benefit reports, summary plan descriptions and the like to all of these deferred vested participants, who, prior to REA, had been cashed out of the plan.

The third area of concern that we have is that the technical corrections bills themselves create confusion. For example, the change in H.R. 2110, which prohibits

the cash out of a divorced spouse's benefits in excess of $3500, is, in our view, ill-considered. Although admittedly not free from doubt, it appeared from Code section 414(p), as added by REA, that a divorced spouse's benefit could be cashed out, subject to the general rules elsewhere in the Code with respect to consent. Even that rule would have vastly increased the recordkeeping of the plan where spousal consent could not be obtained. The "clarification" in H.R. 2110, which was purportedly intended to ease the burden on plan administrators, does not even begin to recognize the added burden caused by these additional account balances. Moreover, there appears to be no valid reason to treat payments to divorced spouses the same as payments to participants. The domestic relations order provisions were intended to facilitate property settlements. They were never intended to create a new class of participants in divorced spouses and grant these individuals equal substantive pension rights. Nor is it clear how amounts subject to qualified domestic relations orders are to be treated: is the amount payable to each spouse tested separately to determine if it exceeds the $3500 threshold or must the amounts be aggregated for this purpose? In the Association's view, unless these amounts can be tested separately, the burden on plan administrators is needlessly multiplied.

A further problem created by confusing language in the technical corrections bills arises as a result of the way the proposed changes in H.R. 2110 on spousal consent relate to H.R. 1800's proposed repeal of Code section 2517.

Under current Code section 2517, the exercise or nonexercise of an election or option under a qualified plan is not considered a transfer for gift tax purposes. H.R. 1800 would repeal this provision, presumably resulting in the imposition of gift tax liability each time a beneficiary designation were made or recorded. This proposed amendment is totally unexplained, and indeed, makes little sense in light of the new spousal consent provisions of REA. Moreover, it is not clear upon whom the liability will fall: if Code section 2517 is repealed, participant designations in favor of a beneficiary other than the spouse may result in gift tax on either the participant, or on the spouse who consents to waive the REA-required spousal annuity. This question is especially difficult in light of the provision of H.R. 2110 which requires the spouse's waiver to acknowledge that the benefit will be paid instead to another named beneficiary. The unlimited revocability of the designation will further complicate the gift tax question.

In addition, there are several other vague provisions in the technical corrections bills, which need to be reworked. The correction to the definition of "fund" in Code section 419 and certain of the amendments to the ESOP rules in H.R. 1800 are confusing; similarly unclear are the consent provisions on loans and the treatment of partially vested separated participants in H.R. 2110. We will be happy to work with the Committee staff in exploring additional areas of concern and providing other technical assistance.

I thank you for this opportunity to testify today.

Mr. GUARINI. Ms. O'Connell.

STATEMENT OF MARJORIE A. O'CONNELL, ATTORNEY, O'CONNELL & KITTRELL, WASHINGTON, DC

Ms. O'CONNELL. Mr. Chairman, thank you for the opportunity to address you and members of the Ways and Means Committee about the technical corrections to the Tax Reform Act of 1984, particularly the domestic relations aspects of the Domestic Relations Tax Reform Act of 1984. Those changes to divorce taxation, which were made last year, changed a 40-year-old system of taxing the alimony payments, the property settlement, and changed the dependency exemptions, the estate and gift tax system, and the innocent spouse provisions for the millions of parties who divorce each year in this country and for their children.

There are technical problems which have arisen in the field already since enactment, particularly as we go into the first days of 1985 after the last of the effective dates. Those provisions have come to my attention as I have traveled across the country meeting with practitioners and talking about State laws and interface with Federal law.

While a lot of their other criticisms of what was done here in Washington have also come to my attention, I want to limit my remarks today to several technical provisions which are most in need of help.

The first is a technical requirement in section 71(b)(1)(d) that a divorce or separation instrument state that for a payment to be a deductible alimony payment, that that payment or stream of payments must terminate at the death of a payee spouse. That is a sensible requirement to distinguish payments for property and entitlement that might extend beyond the death of the recipient spouse from payments for support. Unfortunately, in the conference, a parenthetical phrase was added to the effect that the court decree of divorce or the agreement of the parties or even a temporary support order of a judge between separated parties must state the termination requirement. The problem with that requirement is obviously the unknowing, who would get divorced without counsel, counsel that doesn't know the magic words, and the judges that sit on the bench using preprinted temporary support forms, printed even this year and certainly before enactment, that don't have those magic words.

The requirement is technical, duplicative, and not needed. State law requires that alimony payments terminate at death. So this duplicative trap for the unwary could be eliminated by eliminating the express statement phraseology that came in at conference.

The next provision that needs attention is section 71(f)(1)(a), a requirement that payments be made contingent only upon the death of the payor or the payee or the remarriage of the payee's spouse, another sensible requirement to distinguish between property payments and support payments, however, the requirement as drafted in the statute seemed to leave room that any other contingency could keep an individual from having a deductible alimony payment.

The problem with that is in every jurisdiction where there are court-ordered alimony payments, the court retains jurisdiction to review its own order. Consequently, any American who has a court-ordered alimony payment as opposed to reaching an agreement with some magic words can't have deductible alimony. Probably that is not what the writers of the statute meant. The regulations say that is not what it means. They say that any contingency other than the passage of time until it happens is disregarded. The statute should be amended to adopt the clarification that is in the Treasury regulations as the legal standard in the statute.

The third provision I would like to address is 71(f)(5)(c), a time payment exception to the requirement that payments be made over a 6-year term.

The exception is called the fluctuating payments exception. The statute says that the requirement to make fluctuating payments has to extend for 6 years, a full 72 months, but the requirement to make the payments in the first place over a period of time only has to extend into 6 postseparation years, which can be as little as 50 months under the definition. Thus, the exception to the rule requires a commitment to pay that is longer than the rule requires the payments to be made in the first place.

I think this is an error in phraseology and that the 6 postseparation year period should be applicable both in the rule and in the exception, if there is going to be a required payment there are plenty of other provisions in the statute that guard against the problem that the period of requirement addresses perhaps it could be repealed altogether.

Section 2516 in the estate and gift tax area, was expanded to allow individuals who reach agreements written 1 year after they are divorced to enter into agreements which provide that the gift tax doesn't apply to their transfers.

Unfortunately, the provision which takes the definition of husband and wife to section 2516, and not section 7701(a)(17), is not referred to where it refers to former husband and wife, so we have section 2516 amended to provide for agreements between parties which, within its terms, aren't permitted to make such agreements because they aren't husband and wife, they are former husband and wife. So that technical change needs to be made.

Technical corrections in the innocent spouse rules, which I think are appropriate, are fully set out in my testimony which I hope you will accept for the record today, and I thank you for the opportunity to talk about these changes.

Mr. GUARINI. Thank you.

The other remarks are in the report submitted for the record.

You referred to something, 6 years, 50 months. What did you mean by that?

Ms. O'CONNELL. One of the requirements in the definition for alimony to be deductible, one of the five, is that to the extent that payments exceed $10,000 a year, the payments have to be made over 6 calendar years. If an individual were to make a $25,000 payment, let's say, on December 31, 1985, and then make alimony payments for the next 4 years, that individual could also make a final alimony payment on January 1, 1990, and thereby in 50 different months, one at the end of 1985, 48 in the middle, and the 50th in January of 1990, meet the requirement that the payments extend over a long enough period of time to the extent that they exceed $10,000 and would be deductible.

The problem is that the exception for the deductibility rule used a different phraseology to refer to the 6-year requirement. Instead of paying over 6 post-separation years, which you see could happen in 50 months, the exception says for 6 calendar years, which is a full 72 months.

It is not hard to understand that it is two different tests, but it is a big invitation to confusion and error. I think the 6 post-separation year term is the one that should be uniformly used, if any such test is used at all.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF MARJORIE A. O'CONNELL, O'CONNELL & KITTRELL, WASHINGTON, DC

OUTLINE OF TESTIMONY

I. The domestic relations provisions of the Tax Reform Act of 1984 require technical amendments because of drafting inconsistencies and problems which have arisen under various state laws.

II. Under Section 71(b)(1)(D), the requirement that a divorce or separation instrument must state that the alimony liability ends at the payee's death should be deleted or, in the alternative, should not apply to temporary support orders.

III. Under Section 71(f)(1), the requirement that payments may be contingent only on the death of either spouse or the remarriage of the payee should be amended to incorporate the intended standard which is found in the Temporary Regulations. Temporary Regulation Section 1.71-1T, Q/A 23, provides that any contingency other than the passage of time is ignored until that contingency occurs.

IV. Under Section 71(f)(5)(C), the time period for payments under the exception to the recomputation rules should be the six post-separation year period used for other recomputation purposes.

V. For purposes of Section 2516, the definition of "husband" and "wife" in Section 7701(a)(17), which includes former spouses, should be applied for those Section 2516 cases when agreements are signed after the divorce.

VI. Under Section 6013(e), the innocent spouse provisions in the Tax Reform Act are unnecessarily complicated. The test of "no basis in fact or law" is vague and harsh. The complicated mechanics of the percentage tests in Section 6013(e)(4) are not reasonably related to the purpose of the statute and should be modified.

I. INTRODUCTION

Mr. Chairman and Members of the Committee, thank you for the opportunity to appear at this hearing to testify about H.R. 1800, the Technical Corrections Act of 1985. My name is Marjorie A. O'Connell and I am a tax attorney with the firm of O'Connell & Kittrell in Washington, D.C. I am the author of "Divorce Taxation," published by Prentice-Hall, Inc. My testimony today is about the domestic relations taxation provisions of the Tax Reform Act of 1984.

The Tax Reform Act of 1984 made the most significant changes in the domestic relations provisions of the Internal Revenue Code since the enactment of the alimony deduction in 1942. The Act completely revised the divorce tax law about alimony, property settlements, dependency exemptions, gift and estate taxation, and the innocent spouse rules applicable to joint returns. The new alimony rules under Section 71 have proven particularly difficult for domestic relations practitioners to understand and use for their clients. Since the passage of the Tax Reform Act ten months ago, I have spoken at more than 30 seminars about the new divorce tax rules. My recommendations today include the comments and concerns of attorneys from across the country. Although many of these concerns would require substantive changes, I limit my testimony here solely to technical corrections.

II. SECTION 71(b)(1)(d): PAYMENTS MUST TERMINATE AT THE PAYEE'S DEATH

The thrust of the new provisions of Section 71 is to impose objective requirements to determine which payments are taxable as alimony. One of the principal requirements is that the payments must terminate at the death of the payee. This is a reasonable test to distinguish payments for support from payments in respect of property.

The Conference Committee on the Tax Reform Act added a parenthetical clause which requires that the divorce or separation instrument state that there is no liability to pay after the payee's death. This clause has caused and continues to cause grave problems. If this "magic language" is not in the instrument, none of the payments qualify as alimony. This requirement catches the persons who try to resolve their divorce or separation without legal assistance and those represented by counsel who do not know the "magic words". The purpose of the statute is not served by imposing such an artificial technical requirement on these parties. Under state law, spousal support payments automatically terminate on the death of the recipient, unless special provision is made for continuation of the payments. Section 71 disregards the existence of this state law and sets up its own duplicative test.

The second principal area in which this requirement is causing problems is in the area of temporary support orders. In many jurisdictions, temporary support orders are preprinted forms on which a judge merely enters the names of the parties and the amount to be paid. None of the forms printed before 1985, and probably most forms printed in 1985, would meet the statute's requirement. While these forms will be changed eventually, there are many taxpayers who will make "form order" payments holding erroneous expectations of the tax results. Whenever possible, the Code should try to match taxpayers' reasonable expectations to promote better compliance.

I recommend that the parenthetical clause at the end of Section 71(b)(1)(D) be eliminated. If the clause is not eliminated, the clause should be amended so as not

to apply to temporary support orders defined under Section 71(b)(2)(C). Other provisions of Section 71 do not apply to support orders, in particular the recomputation rules which are excepted under Section 71(f)(5)(B).

III. SECTION 71(f)(1): TERMINATION ON CONTINGENCIES

Under Section 71(f)(1) for payments to be alimony, payments in excess of $10,000 must be made under an obligation to pay in each of the six "post-separation" years. The six post-separation years are the six calendar years beginning with the first alimony payment subject to the recomputation rules. The statute provides that any termination contingent on the death of either spouse or the remarriage of the payee is not to be taken into account. This provision could be interpreted to disqualify any payment which might terminate for any other reason during that period. For example, alimony payments imposed by a court are always subject to termination on a change in circumstances. This contingency imposed by state law could prevent any alimony deductions for court-ordered payments.

The Temporary Regulations provide that a contingency other than the passage of time is ignored until that contingency occurs. Temp. Reg. Section 1.71-1T, Q/A 23. The regulations take the reasonable position that Congress did not intend to disqualify all court-ordered support payments.

I recommend that Section 71(f)(1) be amended to rephrase its intent by incorporating the standard in the regulations. Payments should qualify as alimony under the six-year minimum term rule unless there is a shorter time period stated in the instrument. Any contingencies should be ignored until the contingency occurs. The other possible amendment would be simply to eliminate Section 71(f)(1). The regulations correctly state that the six-year minimum term rule can be met by payment of as little as $1 in any year. The avowed purpose of preventing excess front-loading of alimony in early years is served by the recomputation rules in Section 71(f)(2). The minimum term rule serves no purpose and is an unnecessary complication.

IV. SECTION 71(f)(5)(c): TIME PERIOD FOR FLUCTUATING PAYMENTS

One of the exceptions to the recomputation rules in Section 71(f) is the exception for fluctuating payments as provided in Section 71(f)(5)(C). The recomputation rules do not apply to alimony payments to the extent the payments are made under a continuing liability to pay a fixed portion of income from a business or property, or from compensation for employment or self-employment. The recomputation rules apply over the period of the six "post-separation" years. These years are the six calendar years beginning with the first alimony payment. If the first alimony payment were made in December of a year, that year would be the first post-separation year.

The fluctuating payments exception to the recomputation rules has a different time period which is stated as not less than six years. This six-year period is 72 calendar months, which would usually be a longer period than the six post-separation years. Section 71(f)(5)(C) should be amended to require that payments be made over a period which does not end before the end of the sixth post-separation year, rather than require that payments under the recomputation rule exception extend for a longer period than payments under the recomputation rule.

V. SECTION 2516: DEFINITION OF HUSBAND AND WIFE

Under Section 2516, certain property transfers between former spouses are not subject to gift taxes when made under a written agreement. The Tax Reform Act extended the period during which the agreement could be executed to include the period one year after the parties are divorced. Section 2516 refers to the parties who may execute the agreement as "husband" and "wife". Because the agreement could be executed after the divorce, the parties would not be husband and wife at that time.

Section 7701(a)(17) defines "husband" and "wife" to include a former husband and former wife for purposes of certain sections. Section 7701(a)(17) should be amended to add Section 2516 to the sections to which it applies.

VI. SECTION 6013(e): INNOCENT SPOUSE

The Tax Reform Act expanded the innocent spouse provisions of Section 6013(e). That section applies when a spouse has signed a joint return for a certain taxable year but it would be inequitable to hold that spouse responsible for additional taxes owed for that year because of the actions of the other spouse.

When the erroneous item relates to a claim of a deduction, credit or basis, the innocent spouse must show that the claim had "no basis in fact or law." This is an

unreasonably high standard of proof. There is no similar standard in any other Code provision. The innocent spouse who bears the burden of proof must prove a negative, that the claim of the deduction, credit or basis was without basis and was totally unfounded.

A more appropriate standard would be the standard used for the imposition of the negligence penalty under Section 6653(a). The spouse could establish innocent spouse status when the claim for a deduction, credit, or basis results from intentional disregard of rules and regulations or is due to the negligence of the other spouse. The spouse could not meet the burden when the claim was made in good faith or on reasonable grounds. The law developed under the negligence penalty would give these spouses and the Service guidance in this area.

When a claim of a deduction, credit, or basis is involved, Section 6013(e) also imposes a percentage test to determine whether the spouse qualifies for innocent spouse treatment. If the innocent spouse's AGI in the year before the deficiency was issued was $20,000 or less, the deficiency must be more than 10 percent of the AGI on that year's return. If the spouse's AGI was more than $20,000, the deficiency must be more than 25 percent of that AGI. The AGI includes all of the income on a joint return.

These tests bear no reasonable relationship to the purpose of the statute because the year for measuring the AGI is not related to the year for which the erroneous joint return was filed. For example, assume the innocent spouse filed an erroneous joint return in 1982. If the deficiency is assessed in 1985, the measuring year for the percentage test is 1984. There is no reason to use 1984 as a measurement of whether the spouse was "innocent" in filing the erroneous 1982 return.

These tests are arbitrary in operation. Whether a deficiency is assessed in December of one year or January of the next year can make the difference between "innocence" and "guilt". If a spouse has $1 of income over $20,000, a much stricter test applies to establish innocence. Last, if after the erroneous return was filed, the innocent spouse were to divorce and remarry, the new spouse's income counts with the innocent spouse's income. This rule applies even if the parties would file separate returns, and even though they were not related to each other in the year the erroneous return was filed.

I recommend that Section 6013(e)(4) be eliminated. A more reasonable threshold test for all cases is the $500 understatement amount in Section 6013(e)(3). As an alternative, if the percentage test were retained, Section 6013(e)(4) should be amended to make the year in which the erroneous return was filed the relevant year for applying the percentage test.

VII. CONCLUSION

With the technical corrections I have discussed, the domestic relations provisions of the Tax Reform Act of 1984 would be improved significantly.

I want to thank the Committee for the opportunity to testify today. I would be glad to answer any questions about my testimony.

Mr. GUARINI. Thank you very much.

I am informed that these questions are not crucial, but only if I feel like asking them.

Mr. Golden, I was not here when you testified. Your testimony states that there are other vague provisions in the technical corrections bill which need to be reworked. I refer specifically to the definition of a fund for the purpose of the welfare benefit plan rules and to the employee stock ownership plan provisions.

Would you like to clarify what you think requires additional comment? I thought you might want to expound on that.

Mr. GOLDEN. We are particularly concerned about the definition of fund which I think will be found in section 151(a)(8) of H.R. 1800. I want to associate my comments with those of Mr. Uslander.

The organization by which I am employed as well as the association which I represent are each concerned about the definition of fund. It is mean to be an exemption. It is meant to be a definition whereby if you meet it, it will not be a fund for purposes of the

funded welfare plan provisions added by DEFRA under section 419 and 419(a) of the code.

We would like to work with the staff to make clear what the staff had in mind in terms of language of that definition. It is not clear to us in many cases and we think that could be a helpful exemptive provision. It may not apply to enough people for Congress to bother putting it into the statute.

In the same way the provisions relating to the ESOP rules do need some clarification in terms of section 1042 with respect to when the transactions described therein will take place. They have been cutback and we are not entirely sure as to why.

There are, Mr. Chairman, as I stated, a number of other problems, particularly on the REA which we would be happy to discuss with the staff at its convenience.

Mr. GUARINI. I thank each of you very much for taking the time. We very much appreciate your coming here today. Thank you.

I would like to call Martin D. Wood, Barry R. Schotz, and James Carter.

We welcome you gentlemen.

Mr. Wood, would you like to proceed? We will go in the order that the panel was called.

STATEMENT OF MARTIN D. WOOD, DIRECTOR, RETIREMENT, SAFETY AND INSURANCE DEPARTMENT, NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION, ACCOMPANIED BY PAT McKEITHAN, STAFF ATTORNEY, AND ROB LIVELY, LEGISLATIVE REPRESENTATIVE

Mr. WOOD. Mr. Chairman, I thank you for the opportunity to meet with the committee.

My name is Martin Wood. I am the director of the Retirement, Safety and Insurance Department of the National Rural Electric Cooperative Association.

With me are Pat McKeithan, the staff attorney, and Rob Lively, who is our legislative representative. These are the folks that do all the work.

You have my written testimony, which I request be placed in the record.

Mr. GUARINI. It will be.

Mr. WOOD. It includes the history and technical details and the rationale for the proposals which we make and I do not intend to go into any depth or detail of them.

My reason for appearing this morning is simply to add emphasis to the importance which these seemingly small items have to a large number of people. Also, it is for the opportunity for the committee to ask me questions if they wish.

I am proposing two technical issues: One, that the ability of the Rural Electric Cooperatives to adopt a salary reduction plan which may be appropriately addressed in H.R. 1800.

The other is a proposal for improving methods allowed for calculating the PBGC interest rate for lump sum payments. You may wish to include this in H.R. 2110.

With respect to the first one, the National Rural Electric Cooperative Association provides benefits for in excess of 100,000 employ-

ees and their dependents throughout the country. It is very important to these organizations that they have competent staff, and one of the main features of gaining competent staff, as you well know, is a good compensation plan.

We do have good benefit plans, but we are missing one piece, and that is the piece which is available through the 401(k) route. It is particularly important for the lower-paid employees.

We wish to have the lower-paid employees have the opportunity to form that leg of the so-called three-legged stool of retirement benefits, namely, the personal buildup of retirement benefits, and through 401(k), this can be done. This is not available to us at the present time and that is primarily the result of the national scope of our plans.

We do cover 46 States, 3,600 counties of the 4,000 and as I said, in excess of 100,000 employees.

I would like to emphasize that the change which we seek resolves a problem which is unique to the Rural Electric Cooperatives. It does not alter tax policy, and according to the Joint Tax Committee, has negligible impact on revenues.

I might also say that 11 members of this committee have endorsed the recommended change.

With regard to the PBGC rate, we recognized the desirability of using the PBGC rate some time ago before it became law. We have been using it and therefore have gained considerable experience with it. We offer the benefit of our experience for your consideration.

Our proposal recommends that an average rate over a 12-month period be used rather than a fixed rate either at the beginning of the year or at a month, at a point in time. We feel it is a fairer reflection of the trend of interest rates and it therefore provides a fairer distribution than a PBGC rate in effect for 1 month.

Second, we suggest that a span of 2 years would be desirable. The majority of retirements occur in December and January and a change at the beginning of the year introduces greater variations in the lump sum.

We also suggest, and this is awfully important, that there be a time lag, a 9-month time lag. Retirees need stable retirement projections for retirement planning and this is extremely important.

I suggest that the committee reports accompanying H.R. 2110 provide the commissioner with some flexibility in the use of PBGC rates.

Thank you very much for this opportunity.

Mr. GUARINI. Thank you.

[The prepared statement follows:]

STATEMENT OF MARTIN D. WOOD, DIRECTOR, RETIREMENT, SAFETY, AND INSURANCE DEPARTMENT, NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION

Mr. Chairman and members of the Committee, my name is Martin D. Wood. I am the Director of the Retirement, Safety and Insurance Department of the National Rural Electric Cooperative Association (NRECA) and the Administrator of the various welfare and pension programs sponsored by NRECA and its members. NRECA is the national service organization of the approximately 1,000 rural electric systems operating in 46 states. These systems bring central station electric service to approximately 25 million farm and rural individuals in 2,600 of our nation's 3,100

counties. Our various programs provide pension and welfare benefits to over 110,000 employees and their dependents in those localities.

The purpose of my appearance before you today is to bring to your attention two technical issues—the first concerning the ability of rural electric cooperatives to adopt salary reduction arrangements, which may be appropriately addressed in HR 1800; and the second concerns a proposal for improving the methods allowed for calculating the Pension Benefit Guaranty Corporation (PBGC) interest rate for lump sum payments, which you may wish to include in HR 2110. With your permission, I will begin my testimony by discussing our problems with adopting a section 401(k) plan.

401(k) PLANS AND RURAL ELECTRIC COOPERATIVES

Prior to 1972 the Internal Revenue Service permitted profit sharing, stock bonus and money purchase pension plans to include cash or deferred arrangements. See, Rev. Rul. 68–89, 1968–1 C.B. 402, Rev. Rul. 63–180, 1963–2 C.B. 189, Rev. Rul. 56–497, 1956–2 C.B. 284. These rulings permitted cash or deferred arrangements in profit sharing plans and established a nondiscrimination test of whether a majority of the participants in the plan were in the lowest paid two-thirds of eligible employees. The plans discussed in the early rulings were profit sharing plans giving each participant the individual election to either receive a profit sharing bonus in cash or have the bonus contributed to his account in a profit sharing plan. Although the rulings involved only profit sharing plans, the IRS also issued qualification letters to stock bonus and money purchase pension plans. The rulings (and the early cash or deferred plans) involved only elective contributions to profit sharing plans. However, these types of plans were soon expanded to include arrangements in which employees voluntarily elected to reduce their cash compensation and have the balance contributed to a profit sharing plan. This variation is generally referred to as a salary reduction plan.

On December 6, 1972 the IRS issued proposed regulations which would have changed the result for salary reduction plans and called into question the viability of cash or deferred profit sharing arrangements. In order to allow time to study the area Congress enacted section 2006 of the Employee Retirement Income Security Act of 1974 (ERISA) which temporarily froze the status quo. The IRS was prohibited from enforcing its proposed regulations for plans in existence on June 27, 1974 and no further plans with such features could be commenced until Congress finished its study. This freeze was subsequently extended twice, one in the Tax Reform Act of 1976 and once in the Tax Treatment Extention Act.

The Revenue Act of 1978 added section 401(k) to the Internal Revenue Code, authorizing cash or deferred arrangements in profit sharing and stock bonus plans. Section 401(k) did not authorize cash or deferred arrangements in money purchase pension plans. While proposed regulations extend section 401(k) to cover salary reduction plans, they do not allow money purchase pension plans to adopt 401(k) arrangements. Prop. Treas. Reg. section 1.401(k)–1(a)(1).

The freeze on cash or deferred arrangements in pre-ERISA plans expired January 1, 1980. Since section 401(k) was then in force, the expiration of the freeze did not affect profit sharing or stock bonus plans with 401(k) features. However, there are a number of pre-ERISA money purchase pension plans that had adopted salary reduction arrangements. The expiration of the freeze left them out in the cold since 401(k) applies only to profit sharing or stock bonus plans. Legislation was accordingly introduced in the 97th Congress (H.R. 4948) to provide grandfather protection for money purchase pension plans that before June 27, 1974 had adopted salary reduction arrangements. The primary impetus for action came from a group of money purchase pension plans in the South and Southwest. Those plans principally covered employees of the Federal Land Bank, Bank for Cooperatives, and various production credit associations, most of which are tax-exempt organizations. During hearings on H.R. 4948, Treasury expressed its support of the bill and urged Congress to act to extend the availability of section 401(k) to all money purchase pension plans. Miscellaneous Tax Legislation: Hearing before the Subcommittee on Select Revenue Measures, 97th Cong. 2d Sess. 12 (1982) (Statement of John E. Chapoton). H.R. 4948 died in the closing days of the 97th Congress, however.

H.R. 4948 was reintroduced in the 98th Congress as H.R. 3173, subsequently incorporated into the Tax Reform Act of 1984 as section 527(b), and enacted. During hearings on H.R. 3173, Treasury again stated its support of the concept of extending section 401(k) rules to all money purchase pension plans. Statement of Robert G. Woodward, Tax Legislative Counsel, on H.R. 3173 before the Subcommittee on Select Revenue Measures (September 21, 1983). As provided in the Tax Reform Act of 1984, a

money purchase pension plan with a salary reduction feature in existence on June 27, 1974 may continue the salary reduction feature provided that (1) the contributions to the plan are not increased over the June 27, 1974 contribution formula and (2) the plan meets the special eligibility and discrimination rules of section 401(k).

It is unfortunate that section 527 of the Tax Reform Act of 1984 did not extend section 401(k) to all money purchase pension plans. H.R. 1615, introduced March 20, 1985, and S. 896, introduced April 4, 1985 are intended to clarify that rural electric cooperatives may incorporate 401(k) features into their money purchase pension plans. Rural electric cooperatives are tax exempt, consumer owned utilities operating principally in rural areas of America. The approximately 1,000 rural electric cooperatives operate in 46 states and a majority of the counties of the United States.

H.R. 1615 and S. 896 are actually codifications of the existing ability of tax exempt rural electric cooperatives to adopt salary reduction arrangements. In 1983 a General Counsel Memorandum was released by the IRS which recognized that tax exempt, nonprofit organizations could adopt profit sharing plans. G.C.M. 38283 (February 15, 1980). Relying on G.C.M. 38283 an increasing number of tax exempt organizations have adopted profit sharing plans with 401(k) salary reduction features. Therefore, rural electric cooperatives could possibly take the same approach as other tax exempt organizations and adopt profit sharing plans with 401(k) features. However, such an approach is not advisable because of the unique factors involved with rural electric cooperatives.

Although G.C.M. 38283 permitted profit sharing plans for tax exempt organizations, the National Office of the IRS is not presently issuing opinion letters for such plans with salary reduction features. Therefore, to adopt a 401(k) plan the 1,000 rural electric cooperatives would, contrary to their present practice, have to each individually adopt a profit sharing plan to be approved in the 10 IRS key district offices of the United States. Since not all IRS districts are approving such plans, there would be inconsistencies from region to region. Furthermore, since rural electric cooperatives operate in 46 states, it seems that in at least some states local law might prohibit cooperatives from adopting profit sharing plans. Any excess of revenues over expenses is automatically allocated to the cooperative patrons under state law and not available for contribution to a profit sharing plan.

Thus, while it might be possible for rural electrics to adopt profit sharing plans they do not wish to do so. What they want to do is to incorporate salary reduction features in their existing money purchase plans, which are organized and administered on a national basis. Codification of their ability to do so avoids the problems involved with profit sharing plans and the risk that the IRS might change its opinion in G.C.M. 38283.

Since the treatment of pre-ERISA money purchase pension plans with cash or deferred arrangements was affected in the Tax Reform Act of 1984, it is appropriate to now correct the law to cover certain post-ERISA money purchase pension plans. H.R. 1615 and S. 896 have been reviewed by staff of the Joint Committee on Taxation and found to be of negligible revenue impact.

INTEREST RATE ASSUMPTIONS LUMP SUM PENSION DISTRIBUTIONS

The Retirement Equity Act of 1984 (REACT) requires that the interest rate assumption used in calculating the present value of a pension benefit distributed in a lump sum not be greater than the interest rate used (on the date of distribution) by the Pension Benefit Guaranty Corporation (PBGC) for valuing lump sum distributions on plan terminations. REACT section 205(a). The committee reports state that a plan may provide that the PBGC interest rate in effect on the first day of the plan year be used throughout the plan year. S. Rep. No. 575, 98th Cong., 2d Sess. 24 (1984).

Providing a PBGC referenced interest rate assumption is a salutory change that significantly protects plan participants from unfair or arbitrary interest rate assumptions in valuing lump sum distributions. We feel, however, that the rules provided in REACT are not flexible enough to accommodate the needs of some pension plans in the orderly administration of their pension benefits. To illustrate some of these concerns we will use as an example the multiple employer, master defined benefit pension plan sponsored by the National Rural Electric Cooperative Association (the "NRECA pension plan").

Before the passage of REACT, the NRECA pension plan had provided for the use of the PBGC rate for the calculation of lump sum payments to plan participants. However, the specific method used by the NRECA pension plan does not conform to the REACT specifications in several regards. The NRECA pension plan provides for one PBGC rate to be in effect for the 12 month period from April 1 of one year to

March 30 of the next year. The rate to be used for that period is the average PBGC rate in effect over a 12 month period ending June 30. Thus an average PBGC rate is calculated and then becomes effective nine months later. While the method used by the NRECA pension plan varies from REACT in three ways, each difference is occasioned by significant concerns for the orderly administration of the NRECA pension plan.

1. *Average rates.*—While REACT made no provision for average rates, we feel that a 12 month average is a fairer reflection of the trend of interest rates. It provides over the entire participant population a fairer distribution of lump sum values than a PBGC rate in effect during one month of the year.

2. *Spans two years.*—Since in our experience the great majority of retirements occur on December or January, a change of rate at the beginning of a plan year introduces a great variation in lump sum values among retirees. We are also greatly concerned with the administrative difficulty of changing the lump sum calculation in the middle of the most active retirement period.

3. *Nine month lag.*—Potential retirees need stable retirement projections and time to plan for their retirement. We, therefore, allowed a period of nine months from the calculation of the interest rate until it became effective to allow for participant planning before their retirement actually occurs.

While we agree with the need to specify PBGC interest rates for lump sum calculations, we fear that there is not sufficient flexibility provided in REACT to enable the IRS to approve pension plans that may, for good administrative reasons, have variations on the REACT specified method. We therefore suggest that the committee reports accompanying HR 2110, Making Technical Corrections to the Retirement Equity Act of 1984, provide that the Commissioner may issue favorable determination letters to plans providing for PBGC rates in calculating lump sum amounts by methods the Commissioner finds reasonable under the circumstances. The circumstances to be considered should include the orderly administration of the plans, predictability of the lump sum amounts and consistency among the plan participants. For example, an average PGBC rate or one covering a twelve month period spanning two plan years could be permitted by the Commissioner.

This concludes my testimony on the need for clarifying the ability of rural electric cooperatives to adopt salary reduction arrangements and our proposal to allow additional flexibility in the calculation of the PBGC interest rate for lump sum distributions. I remain willing to respond to any questions the Committee may have now or after this hearing.

Mr. GUARINI. I understand that Mr. Carter is not here, but you are here in his stead?

Would you state your name and position and go forward, please.

STATEMENT OF JAMES M. CARTER, SENIOR TAX COUNSEL, ICI AMERICAS, INC., AS PRESENTED BY TOM HINDMARCH

Mr. HINDMARCH. I am Tom Hindmarch, a tax attorney with ICI Americas Inc. I will be speaking for Mr. Carter. My testimony will summarize Mr. Carter's written statement.

We are here to propose a technical correction to H.R. 1800 dealing with voluntary employee beneficiary associations.

I am speaking here on behalf of the three voluntary employee beneficiary associations [VEBA's] in which the majority of our employees participate. All three VEBA's are funded with aftertax dollars of the participating employees. The company obtains no tax advantage whatsoever from the VEBA's since they are strictly employee payall. The company does not receive a deduction.

We intend to point out how the amendment to the Internal Revenue Code section 512 dealing with unrelated business income made by the Deficit Reduction Act of 1984 inadvertently penalized the nonabusive, employee payall VEBA and probably unintentionally subsidized the insurance industry.

Under the Deficit Reduction Act of 1984, the income of VEBA's funded substantially by aftertax employee contributions will

become subject to the unrelated business income tax in 1986. This result follows from new code section 512(a)(3)(E) that treats income generated from a reserve in excess of permissible set-aside as subject to tax under code section 511.

The permissible amount is the qualified asset account limit determined under code section 419(A), which is a corollary to 419 dealing with employer deductions. Code section 419(A), as currently drafted, will limit the permissible reserves to zero if benefits are provided through an insurance policy or to the amount of December claims paid the following January where benefits are paid directly by a VEBA.

Such a reserve is generally insufficient to provide life insurance or disability benefits in an employee funded VEBA. An employee-funded VEBA must have a reserve to avoid rapid contribution fluctuations. No employee-funded life insurance or disability benefit program could retain enough participation to survive if it had to change the contribution amount constantly. Thus, employee funded life insurance or disability VEBAs must either move all funds over to an insurance company or pay the unrelated business income tax.

The employees will ultimately have reduced benefits either due to the tax or the lower rate of return on investment if insurance companies instead of VEBA's maintain the premium stabilization reserves. The net effect of code section 512, as amended, is to penalize employee-funded VEBA's and provide commercial insurance companies a further profit at the employee's expense.

The foregoing result does not appear to be what Congress intended when they attacked the abusive use of VEBA's by employers who were front-loading deductible contributions to VEBA's and using the contributed amounts to fund employer obligations under ERISA welfare plans essentially tax free.

Congress apparently recognized there is no abuse where contributions to a VEBA are not deducted by an employer, since code section 512(a)(3)(E)(iv) exempts VEBA's funded by tax-exempt employers. We believe that the same result should follow for an employee payall VEBA since neither the employees' contributions nor the investment income of the VEBA reserve is deductible.

Additionally, we believe that the current structure of code section 512(a)(3)(E)(iv) effectively revokes code section 501(c)(9). The whole purpose of code section 501(c)(9), which was to permit employees to accumulate income on a tax-free basis to provide life, sick, death, disability and other similar benefits, has been subverted by the mechanics of code section 512(a)(3)(E)(iv).

On behalf of the three VEBA's that I am representing today, it is recommended that we add a new clause to subparagraph (E) of section 512(a)(3) to read as follows: "This subparagraph (E) shall not apply to an organization described in paragraph (9) of section 501(c) if substantially all the contributions to such organization are made by employees."

The technical correction would be made in section 151(a)(10) of H.R. 1800. The exact language of the proposed correction is set out in Mr. Carter's statement.

In quick summary, we believe that an employee funded VEBA should not be subject to tax and should receive the same treatment as a tax-exempt organization VEBA.

That, in essence, is the end of my statement. If you have any questions, I would be glad to answer them.

[The prepared statement of Mr. Carter follows:]

STATEMENT OF JAMES M. CARTER, SENIOR TAX COUNSEL, ICI AMERICAS, INC.

My name is Jim Carter, Senior Tax Counsel, ICI Americas Inc., a Delaware corporation. This statement is made on behalf of three Voluntary Employee Beneficiary Associations ("VEBAs"), exempt from taxation under Internal Revenue Code ("Code") section 501(c)(9), that provide life insurance or long term disability insurance to more than 8,000 participants. All three VEBAs are funded entirely with the after tax dollars of participating employees of ICI Americas. ICI Americas obtains no tax advantage from these VEBAs since the Company makes no contributions to them. Participation is entirely voluntary. My testimony will point out how amendments to Internal Revenue Code section 512 made by the Deficit Reduction Act of 1984 ("DRA") inadvertently penalize non-abusive, employee payall VEBAs and, probably unintentionally, subsidize the insurance industry. We request relief in the Technical Corrections Act of 1985.

Two of the subject VEBAs provide only group term life insurance. The third one provides long term disability benefits with an ancillary death benefit. Participants make contributions at a level rate and the VEBAs, through a bank trustee, pay the premiums for group term policies to an insurance company. The premiums are experience rated. A premium stabilization reserve is held by the trustee to prevent contribution fluctuations.

In 1986, the income of FEBAs funded substantially by after tax employee contributions becomes subject to the unrelated business income tax. This result follows from new Code section 512(a)(3)(E) that treats income generated from a reserve in excess of the permissible amount as subject to tax under Code section 511. The permissible amount is the qualified asset account limit determined under Code section 419A. Code section 419A, as currently drafted, effectively limits permissible reserves (1) to zero if benefits are provided through an insurance policy or (2) to the amount of December claims paid the following January where benefits are paid directly by a VEBA. Such a reserve is generally insufficient to provide life insurance or disability benefits in an employee funded VEBA. An employee funded VEBA must have a reserve to avoid rapid contribution fluctuations. No employee funded life insurance or disability benefit program could retain enough participation to survive if it had to change the contribution amount constantly. Thus, employee funded life insurance or disability VEBAs must either (1) move all funds over to an insurance company or (2) pay the unrelated business income tax. The employees will ultimately have reduced benefits either due to the tax or the lower rate of return on investment if insurance companies instead of VEBAs maintain the premium stabilization reserves. The net effect of Code section 512, as amended, is to penalize employee funded VEBAs and provide commercial insurance companies a further profit at the participants' expense.

The foregoing result does not appear to be what Congress intended when they attacked the abusive use of VEBAs by employers who were front loading contributions to VEBAs and using the contributed amounts to fund employer obligations under ERISA welfare plans essentially tax free. Congress apparently recognized there is no abuse where contributions to a VEBA reserve are not deducted by an employer, since Code section 512(a)(3)(E)(iv) exempts VEBAs funded by tax exempt employers from the new set-aside rules and thus excludes a tax exempt organization's VEBA from the unrelated business income tax. The same result should follow for an employee payall VEBA since neither the employees' contributions nor the investment income of the VEBA reserve is deductible.

The very purpose for which Code section 501(c)(9) was enacted was to permit VEBAs tax free accumulations of income for the purpose of providing life, sick, accident, and similar benefits. If Congress intended to deny the traditional non-abusive use of Code section 501(c)(9) by employees, Code section 501(c)(9) should have been expressly repealed rather than eviscerated by addition of a fifth subparagraph to a third paragraph of a subsection of a statute apparently aimed at employer deduction-funded VEBAs. But the statutory structure and the absence of discussion of this issue in the legislative history indicate that Congress did not intend to attack non-abusive, employee payall VEBAs. If, indeed, it was Congress' intent to tax the investment income of such a VEBA, then the clear beneficiary is the insurance industry and the clear losers are the participants.

On behalf of the three VEBAs represented here today, it is recommended that a new subparagraph (E) be added to section 151(a)(10) of H.R. 1800, to read as follows:

(E) A new clause (iv) is added to section 512(a)(3)(E) to read as follows:

(iv) This subparagraph (E) shall not apply to an organization described in paragraph (9) of section 501(c) if substantially all the contributions to such organization are made by employees.

I am at your disposal to answer questions concerning the position advocated. Thank you for your attention.

Mr. GUARINI. Your company is located in Bayonne, NJ?

Mr. HINDMARCH. We have a plant in Bayonne. Our headquarters is in Wilmington, DE.

Mr. GUARINI. Bayonne is in my district.

Mr. Schotz, you are president of CCI.

STATEMENT OF BARRY R. SCHOTZ, PRESIDENT, CCI

Mr. SCHOTZ. I apologize for being late. Also, my written testimony is somewhere between here and San Diego on one of the planes I took to get here. I have been in five cities in the past 12 hours.

We have tried to create again the material in the last hour and a half, so it will be rather sketchy, but copies will be available by this evening.

Mr. GUARINI. We will include it in the record when it arrives. It will be kept open for the benefit of your comments.

Mr. SCHOTZ. We appreciate the opportunity to appear before the House Ways and Means Committee today to discuss the Technical Corrections Act of 1985.

In particular, we would like to focus our comments on three particular problem areas with respect to funded welfare benefits plans. Although we have had other corrections with provisions of DEFRA after it was passed, we have other items that still need to be corrected.

However, before we get into that, we would like to compliment the staff for coming up with what we consider to be a minor number of technical corrections needed in this act.

First, we would like to comment on section 419(a)(C)(5)(A) requiring actuarial certification for levels of contributions to funded welfare plans. We feel that this may be an oversight in that actuarial certification may not be required for contribution to and above what is known as the safe harbor limits.

As opposed to that, we would recommend that they come from an already existing source of reliable information, third party claims administrators. This information is readily available and has been used by not only the Treasury Department but also the Joint Committee on Taxation in the past to formulate with some of their recommendations for the DEFRA Act.

This could be provided on a form to be discussed by the Treasury Department in cooperation with third party claims administrators. It has been our experience that actuaries do not have practical experience in the funded welfare plan area as opposed to the qualified retirement plan area or insurance reserves.

Additionally, we would like to recommend or extend the services of our society, the Society of Professional Administrators, whom I do not represent today, in helping to prepare such a form that would be acceptable to Treasury.

Therefore, in section 419(a)(C)(5)(A), we would recommend that after the word "certification" some recommended language, that is, or a form to be jointly prepared by Treasury should be added.

Continuing, we would also like to look at section 419(e), an addition of paragraph 4, which requires that a contract not be guaranteed renewable in order to be outside the definition of a fund. We feel that there are several occasions that happen quite often that may have been overlooked.

For example, this may easily be construed to encompass a traditional insurance arrangement by the name of split dollar insurance whereby the result could very easily be that a key employee, even though he receives coverage on a nondeductible basis, at his death, which many times occurs after he has terminated his employment, could be subject to a 100-percent excise tax penalty.

We feel in looking at the conference committee reports that this is inconsistent with the conferees' intentions.

Additionally, many small employers are required by the insurance industry to utilize individual contracts that contain an already guaranteed renewable clause, and therefore these employers would be subject to the potential of the 100 percent excise tax penalty on a dividend or a distribution back to the sponsoring employer under traditional contracts that already qualify under section 79 of the code as group term insurance.

We do not see any consideration for this in the technical correction. We have calculated numbers on this area, the creation of a fund by a smaller employer—by utilization of these individual annual renewable term contracts would cause the rates to be increased unnecessarily and would put these employees at an unintended economic disadvantage.

Therefore, we strongly urge a redrafting of the proposed technical corrections language to exclude these arrangements. Thank you for your time.

Mr. GUARINI. Thank you, Mr. Schotz.

[The prepared statement follows:]

STATEMENT OF BARRY R. SCHOTZ, PRESIDENT, CCI

We appreciate the opportunity to appear before the House Ways and Means Committee today to discuss certain aspects of the Technical Corrections Act of 1985 and the related provisions of the Tax Reform Act of 1984 ("DEFRA"). In particular, we would like to focus our comments on two particular problems that continue with respect to funded welfare benefit plans. Although we had other technical concerns with the provisions of DEFRA after it was passed, we are pleased with most of the changes relating to funded welfare benefit plans and commend the Committee and its staff on most of the changes proposed in H.R. 1800.

The two problems that we would like to discuss are Section 419(e), as proposed to be amended by new paragraph (4), and Section 419A(c)(5)(A). First, we believe that the definition of "funds", prior to the addition of the proposed new paragraph (4), could be construed to include so-called "split-dollar" insurance arrangements. These arrangements provide death benefits to covered employees during their working lives, are funded by life insurance contracts (the premiums of which are paid by the employer and the employee or otherwise included in the gross income of the employee), the contracts have cash surrender values, and they are usually maintained on the lives of key employees.

We do not find any evidence in the Congressional reports to suggest that Section 419 was intended to cover such arrangements (which are maintained on a non-deductible basis), but the addition of paragraph (4) seems to specifically extend Section 419(e) to split-dollar insurance arrangements and remove any doubt that such arrangements are to be treated as "funded" welfare benefit plans.

If this is the result of the addition of paragraph (4), whether or not intended, the consequence would be that benefits paid to the majority of these covered employees will be subject to the 100% excise tax imposed by Section 4976, because in many instances the benefits are paid subsequent to an employee's termination or retirement. Furthermore, the employer's recuperating of its premium under such arrangements would be subject to the excise tax in any case, and we cannot believe that such a major change in tax policy is contemplated through a technical correction of a defined term in DEFRA.

More importantly, however, proposed paragraph (4) seems to include a large number of different types of insurance contracts which appear to be excluded under the Conference Committee Report for DEFRA. In particular, traditional arrangements for purchasing what are construed to be "renewable" contracts for smaller employers under Section 79 plans contain a right of renewal by their very nature. Whether such renewal features are guaranteed is uncertain, with the result that contracts which commonly have been considered group insurance (with no potential for abuse) becomes a "funded" welfare benefit plan under Section 419. This would cause unnecessary economic hardship on smaller employers (and on their respective employees). The reason for this hardship would be that the payment of policy dividends paid to the employers who own these contracts [which is specifically contemplated under proposed paragraph (4)(A)(ii)] would constitute receipt of plan assets and be subject to the excise tax imposed by Section 4976. Therefore, we strongly urge an exception for these particular employers and plans or redrafting of the proposed language.

Second, Section 419(A)(c)(5)(A) should have added, after "certification" the following language—"or its equivalent to be prescribed in an acceptable format by the Department of the Treasury". The reasons for this needed addition are as follows: First, There is little or no formal training or expertise by "enrolled" actuaries in the field of funded welfare benefit plans. Second, Current expertise already exists in many third party administrators and should be utilized appropriately without unnecessarily encumbering either the Treasury Department or the plans. Third, This expertise was utilized in accumulating and reviewing the appropriate data on which many portions of Section 419 and 419A were based (especially the qualified asset account limits). Fourth, The Society of Professional Benefit Administrators has available a large number of participants from a fair cross section of third party administrators (representing approximately 50% of all welfare benefit programs currently in existence) so as to provide the necessary input to the Treasury Department for it to develop a standard format that could be used to streamline the review of the appropriate standards and safeguards desired by the Conference Committee in requiring "actuarial certification" for funded welfare benefit plans.

We thank you for your time and are prepared to answer any questions that you may have.

Mr. GUARINI. Mr. Wood, have you made any revenue estimates—you cover, I understand, 46 States and you said 3,600 counties or some figure that I think I recall. For allowing rural electric cooperations to have 401(k) plans, what would it cost the Government?

Mr. WOOD. I think when I made my testimony, I referred to 3,600 out of 4,000 counties. I think that is 2,600 out of 3,000.

Mr. GUARINI. In 46 States?

Mr. WOOD. In 46 States, that's correct.

We do have a statement from the staff director for the Joint Committee on Taxation, Mr. David Brockway, who has made an estimate. It does not have numbers in it.

I cannot answer your question directly, but I would like to ask that this be submitted as part of my testimony, his comment, which in essence says that it would have minimal effects.

[The letter follows:]

CONGRESS OF THE UNITED STATES,
JOINT COMMITTEE ON TAXATION,
Washington, DC, April 25, 1985.

Hon. WYCHE FOWLER,
House of Representatives, Washington, DC.

DEAR MR. FOWLER: We are responding to your request for a revenue estimate of the effect of extending the qualified cash or deferred arrangement rules (sec. 401(k) of the Code) to certain money purchase pension plans.

We estimate that this proposal will have a negligible effect on budget receipts. Our analysis is based on the draft language submitted to us by Bill Johnstone on January 28, 1985, which limits the extension to the pension plan maintained by the National Rural Electric Cooperative Association and its member cooperatives.

If we can provide you with any further assistance, please contact us.

DAVID H. BROCKWAY.

Mr. GUARINI. Minimal is described as what sum of money?

Mr. WOOD. It says it was so low, it couldn't be measured.

Mr. GUARINI. In Washington sometimes minimal is anything under a billion dollars. Would this open the door to any other nonprofit groups?

Mr. WOOD. Not that we are aware of.

Mr. GUARINI. You don't think that it would cause the floodgates to open and others would want to have the same advantage?

Mr. WOOD. We have heard nothing from any others along this line.

Mr. GUARINI. Gentlemen, I thank you very much for giving us your testimony. We certainly will take heed to the suggestions you have made. Thank you very much.

I call Gerald Katz, Venable, Baetjer & Howard; Steven D. Kittreli, O'Connell & Kittrell; and Ethan Lipsig, counsel to Baker International, Lockheed, Northrop, and TRW; Harry James and James O'Brien, with Pan Am World Services; and Jarred Metze, Flagship International, Sky Chefs.

I welcome all of you here. Your prepared testimony will be placed into the record. You can either read from your testimony or summarize it as you so wish.

We will begin with Gerald Katz.

STATEMENT OF GERALD M. KATZ, PARTNER, VENABLE, BAETJER & HOWARD, BALTIMORE, MD

Mr. KATZ. Thank you, Mr. Chairman. I appreciate the opportunity to be here.

My name is Gerald M. Katz. I am an attorney in Baltimore with Venable, Baetjer and Howard. I have been practicing tax law, and pension law for some 22 years, even before it was the vogue, I guess before ERISA.

I wish to address in particular section 303, the transitional rule of the Retirement Equity Act of 1984 [REA].

REA created, as you know, the preretirement annuity and the joint and survivor death benefit annuity. These provisions were made generally effective for the first plan year beginning after December 31, 1984.

Mr. GUARINI. Could you speak into the microphone?

Mr. KATZ. I am addressing specifically the preretirement annuity and the death benefit survivor annuity provisions that were added

by REA. The general application of these provisions is to the first plan year beginning after December 31, 1984.

The transitional rule, however, in effect appears to make these provisions effective for all participants who had service after the effective date of the act, August 23, 1984. The result has been confusion as to whether the designated beneficiary of a participant was entitled to a benefit in the interim period, or whether the participant's surviving spouse was entitled to that benefit, a so-called double benefit problem for plan administrators.

The proposed legislation attempts to solve that problem by saying that for participants who die during the transitional period, after August 23, 1984, until the beginning the first plan year after December 31, 1984, that the plan would not have to pay a double benefit.

My concern is that the proposed Technical Corrections Act addresses the problem in the wrong way. It attempts to merely shoot bullets at some issues but doesn't really get to the heart of the problem. The problem is that plan sponsors and plan administrators were not given sufficient time to amend their plans, to determine how to amend their plans, or to determine whether the plans should be terminated.

What Congress has said is "Here is a new law; it is effective on the day we pass it and everybody has to figure out what to do with it. And we are going to try to solve the problem of double benefits." But, in my opinion, it won't solve the problems because of the numerous issues raised by designated beneficiaries who don't get their benefits.

The problem is two-fold. One is for the plan sponsors who could not amend their plans or have not amended their plans, and for plan administrators who have to interpret who gets benefits. And second, it is a problem for the designated participants who are not going to get benefits because of this law change, or who have to go to court to try and argue that the law change was not proper.

We are looking at fairness to the designated beneficiaries and the fairness to the plans and administrators. To illustrate what some of the problems are, say we have a participant who dies on August 24, one day after the effective date of the statute. He designated his children as his beneficiaries under the plan. The plan was not amended.

He wasn't aware that the day before he died, the law had changed. He was not advised by his company. All of a sudden, his spouse may have a right to his benefit.

It is not fair to the participant, and it leaves an issue to be litigated between the children and the spouse, even in the case where the spouse might have joined with him in deciding that the children should be the beneficiaries.

Second example: We have a disputed marriage situation where the participant dies, perhaps with a smile on his face, knowing that his children by his first marriage are the designated beneficiaries under the plan. The participant was in contested divorce proceedings at the time of his death. He was not aware that the law had been changed a few days before he died. Nor was he aware that after he died, Congress would make the employer amend the plan to say that "Even though you have already died, and even though

you have your benefit designated to your children, we are going to take that benefit away from them."

A third example might be a female professional, a physician who has a one-person incorporated practice. She has had a pension plan in her corporation for 20 years, accumulated money for 20 years and she is in a contested divorce situation. Under the transitional rule, she doesn't have time to decide whether she wants to terminate her plan and avoid the problem altogether.

Congress has always given some notice of change, so that if an employer desired to terminate a plan, it could. But because of the effective date of this transitional rule, it is highly questionable whether the doctor in my example can terminate her plan without having a possible claim by her estranged spouse.

My suggestion would be that the effective date of this death benefit annuity provision should be deferred, perhaps until 1986. At least, the transitional rule should be eliminated so that the effective date of the annuity provision doesn't apply until the first plan year beginning in 1985. Perhaps, as a minimum, we can say that these rules don't apply to anyone who is already deceased. In other words, employers don't have to amend their plans to say if somebody has already died without knowing about this, he will nevertheless lose the benefit. Thank you.

[The prepared statement follows:]

STATEMENT OF GERALD M. KATZ, ESQ, VENABLE, BAETJER & HOWARD, BALTIMORE, MD

Mr. Chairman and members of the committee, my name is Gerald Katz. I am a partner in the law firm of Venable, Baetjer and Howard, which has its principal offices in Baltimore, Maryland. I am the Department Chairman of our firm's tax department, and I have practiced in the pension area for over 22 years. Venable, Baetjer and Howard represents over 500 retirement plans, ranging in size from one participant to several thousand participants.

I appreciate the opportunity to present my views on the proposed corrections to the Retirement Equity Act of 1984. In particular, I wish to focus on the proposed amendment to Section 303 of the Retirement Equity Act. That Section deals with the transitional rule for the requirement of joint and survivor and pre-retirement survivor annuities.

I believe that Congress had a commendable purpose in enacting the Retirement Equity Act last summer. However, I also believe that some of the Act's provisions are not well tailored to achieve that purpose. In the midst of the hue and cry to pass the Act, serious practical and equitable issues were not thoroughly considered.

As enacted, the Retirement Equity Act requires that pension plans and certain profit sharing plans provide joint and survivor and pre-retirement survivor annuities to spouses of plan participants. A participant may waive the survivor annuity benefits only by obtaining the written consent of his or her spouse within prescribed time periods.

The Act in general provides that a pre-retirement survivor annuity and a joint and survivor death benefit will be required for surviving spouses beginning with the plan year that begins after December 31, 1984. However, Section 303 of the Act contains a special transitional rule that in essence may have made the pre-retirement survivor annuity requirement effective immediately as of the date the Act was signed into law, rather than for plan years beginning after December 31, 1984.

This transitional rule has given rise to a number of questions. One of the most perplexing questions concerns participants who had previously designated persons other than their spouses as the beneficiaries of their death benefits. If a participant validly designated a non-spouse beneficiary prior to August 23, 1984, and died after that date without obtaining the required consent of his or her spouse to waive the pre-retirement survivor annuity, the plan administrator was placed in a quandary. In most of these cases, the sponsoring employer had not amended the plan to comply with the Retirement Equity Act and plan participants had not been notified of the Act's provisions. As such, it is not clear under the Act whether the plan

should pay benefits to the participant's designated beneficiary, to his or her surviving spouse, or to both. The plan could thus be liable for payment of double death benefits.

The proposed Technical Corrections Act you are now considering addresses the double death benefit question. It provides that the amount of death benefits payable to a designated beneficiary should be decreased by the amount required to provide a pre-retirement survivor annuity for the participant's surviving spouse.

In my opinion, the proposed amendment to the transitional rule does not go far enough. The amendment fails to address other practical problems and, more importantly, the basic inequities inherent in the transitional rule. For reasons outlined below, I advocate that Congress should delay the effective date for the survivor annuity requirements until the first plan year beginning after December 31, 1985, or eliminate the transitional rule altogether, or at a minimum, eliminate retroactive application of this rule to deceased participants.

PRACTICAL CONSIDERATIONS

The special transitional rule presents myriad administrative problems for plan administrators. In the real world, few, if any, administrators were equipped to immediately comply with the new spousal consent requirements at the time the Retirement Equity Act was signed into law. Administrators must first understand how the Act applies to their plans. This is not an easy task, given the complexity of the annuity requirements. New procedures must be designed, and revised benefit election forms must be drafted and distributed to participants. Many plan administrators are still trying to work out the details.

EQUITABLE CONSIDERATIONS

The practical problems serve to highlight how inequitable the transitional rule is in application. As enacted, the transitional rule did not give a plan sponsor any time to evaluate whether a pre-retirement survivor annuity is a desirable form of benefit under its particular plan.

The law does not require an employer to maintain a retirement plan for its employees. An employer adopts a pension plan only after carefully considering how the existing law applies to its situation. Of course, the employer may need to revise plan provisions as the law changes. Generally, however, when enacting significant changes to pension laws, Congress allows sufficient time for employers to revise their plan provisions. It is only fair that an employer have adequate notice and the opportunity to amend or terminate a plan because of changes in the law.

The transitional rule is particularly unfair to plan participants. Consider a participant who made an informed, considered decision to leave his or her death benefits to his or her children. In many cases, this decision was jointly made with the participant's spouse, perhaps as part of an overall estate plan for the couple. Assume that the participant died on August 24, 1984, one day after the Retirement Equity Act was signed into law. Because of the special transitional rule, the pre-retirement survivor annuity requirement would apply to that participant. The plan administrator is caught in the middle—should he pay out the death benefits to the participant's children and provide a pre-retirement survivor annuity to the participant's spouse?

This example exemplifies the double death benefit problem addressed in the Technical Corrections Act. The proposed legislation may eliminate double benefits, but it still does nothing for the deceased participant who did not know of the law change, nor does it help the children. The proposed amendment to Section 303 does not correct the basic inequity in this situation—namely, that the participant's expectations are defeated without his or her knowledge or consent. In effect, the transitional rule takes away a participant's right to make decisions about his or her own life.

Consider next the case of a participant who dies with a smile on his face, knowing that he left his death benefit under his pension plan to his children and not to his estranged spouse. He died with a smile because he knew that the plan provisions specifically provided that he could designate a beneficiary of his own choosing. Little did he know that a few weeks prior to his death, the Retirement Equity Act had been passed. Further, not in his wildest dreams could he imagine that after his death, the plan would be amended to provide that a portion of his benefit would have to go to his estranged spouse. In fact, depending on how the plan was written, the entire benefit might go to his estranged spouse. This is neither fair nor equitable, and may in fact be constitutionally improper.

Consider also the female physician who has an incorporated medical practice. She has faithfully contributed to her corporation's pension plan for twenty years. It so

happens that at the time that the Retirement Equity Act is passed, she is in the process of divorce litigation with her second husband. Under her pension plan, she has designated the children by her first marriage as the beneficiaries of her plan benefit. The first plan year for her pension plan after December 31, 1984, begins on July 1, 1985. In light of the drastic change in the law, so far as her situation is concerned, it is only fair and equitable that she be given the opportunity to make an informed decision on where her pension assets will go in the event of her death. As one option, she should have the right to terminate the plan before the effective date of this new provision. Congress should not be able to change overnight what it has taken her twenty years to accumulate.

An unfortunate result of the transitional rule is that it will force employers, plan administrators, and beneficiaries into litigation to decide who should rightfully receive a deceased participant's death benefits. This is not an idle prediction. Disputes over death benefits have arisen throughout the country. Such litigation would be totally unnecessary if Congress would grant sufficient time for employers to amend their pension plans without making the pre-retirement survivor annuity requirement applicable to deceased participants.

The legislation now being proposed to amend Section 303 of the Act will simply prescribe that a double death benefit will not be due by the plan for the transitional period, i.e., between August 24, 1984, and the first day of the plan year beginning after December 31, 1984. This legislation approaches the question in the wrong way. Instead of focusing on trying to avoid the double benefit problem for the transitional period, Congress would treat plan sponsors and deceased plan participants and their beneficiaries more equitably by delaying the effective provisions for a reasonable period. Further, the proposed legislation does not really solve the problem. For example, Congress can say that there won't be a double benefit due by the plan during the transitional period, but this will probably result in more litigation than is currently contemplated. We will still have designated participants arguing that the law is unconstitutional, that vested rights are being taken away from participants or beneficiaries in contravention of Section 204 of ERISA, and that the beneficiaries have the right to receive the benefits in accordance with the plan provisions in existence at the date of the participant's death. Rather than solving the problem, the new legislation will probably raise further technical issues.

In summary, I submit that the present proposal to amend the transitional rule does not address the real problem—namely, that it was impractical and inequitable to make the pre-retirement survivor annuity requirement immediately effective. Plan sponsors and participants should have notice and the chance to evaluate the impact on their individual situations. After weighing the various factors involved, an employer may voluntarily wish to amend its pension plan retroactively to make the death benefit requirement applicable to 1984 plan years. That decision should be left up to the employer. At a minimum, an employer should not be forced to amend its plans retroactively to change the death benefits of participants who have already died. The only sensible approach is to defer the mandatory effective date of the pre-retirement annuity and joint and survivor death benefit annuity provisions for a reasonable time.

Mr. GUARINI. Mr. Steven Kittrell.

STATEMENT OF STEVEN D. KITTRELL, O'CONNELL & KITTRELL, WASHINGTON, DC

Mr. KITTRELL. My name is Steven Kittrell. I practice law in the areas of retirement benefits and domestic relations. I appreciate the opportunity to testify about H.R. 2110, which makes amendments to the domestic relations provisions of the Retirement Equity Act of 1984.

The Retirement Equity Act created the first Federal statutory rules about treatment of retirement benefits in divorce. Overall, the act does an excellent job of balancing concerns of divorcing spouses and plan administrators in this sensitive area.

However, I believe there are technical issues which should be addressed in H.R. 2110 which are not currently in the bill.

The first technical correction I recommend relates to the form in which benefits may be paid to an alternate payee. An alternate

payee under the statute is a person, normally a spouse or former spouse, who is entitled to receive a part of the participant's benefits under a domestic relations order.

The act currently contains a special rule that benefits may not be made in the form of a joint survivor annuity to the alternate payee and the alternate payee's subsequent spouse. Because it is limited to the case where benefits are paid before the participant has separated from service, I believe that this restriction should be eliminated.

The alternate payee is treated the same as the participant for most purposes under the Retirement Equity Act and a former spouse should be allowed freedom to elect any form of benefit available under the plans. Freedom to choose the benefit form is an important right of a participant or an alternate payee.

The second technical correction I would recommend relates to taxation of payments to an alternate payee. The act provides that an alternate payee is to be taxed in the same manner as the participant.

H.R. 2110 would limit this rule to cases where the alternate payee is a spouse or former spouse. This would eliminate such problems as having child support payments being taxable to the child who receives them. What H.R. 2110 does not do is clarify what the tax results should be to the alternate payees who are not spouses or former spouses.

I believe that the proper rule is for the participant to be treated as having received the full amount of the benefits and then having transferred part of the payment to the alternate payee who is not a spouse or former spouse. The participant would be taxed on the full amount of the payments.

Under this proposal, the tax results to the participant and to the alternate payee would be the same as if the plan were not involved.

The third provision which I believe requires further technical amendment relates to payments made before the participant separates from service when those payments are made to the alternate payee.

H.R. 2110 would provide a new rule for plans which are otherwise prohibited from paying benefits before a participant terminates employment—this is normally a defined benefit plan or section 401(k) plan. In these instances, the plans could pay benefits to an alternate payee while the participant remains in service, but only if the value of the benefits is $3,500 or less.

I believe that rule is inconsistent with the intent of the Retirement Equity Act, and should be expanded to allow the plan and the alternate payee to agree that benefits can be paid in a lump sum to the alternate payee whenever the domestic relations order is entered.

This is an issue that affects both large and small plans. Large plans want to avoid the administrative costs of dealing with potentially thousands of former spouses. In small plans, often the participant is also the administrator and the trustee of the plan, and allowing a cash-out of the alternate payee would enable the parties to completely sever their relationships with the plan and with each other.

My final recommendation deals with the ability of an alternate payee to designate a legal representative to deal with the plan about a domestic relations order. The statute could be interpreted as not applying during the important period of time before the order is deemed to be qualified. Some clarifying language would be helpful to ensure that the alternate payee has the right to legal representation while the order is being considered for qualification.

In conclusion, I would like to say that the domestic relations provisions of the Retirement Equity Act have been of substantial benefit to divorcing spouses and could be improved by further technical corrections. I hope my testimony will be of assistance to the committee.

Mr. GUARINI. Thank you.

[The prepared statement follows:]

STATEMENT OF STEVEN D. KITTRELL, O'CONNELL & KITTRELL, WASHINGTON, DC

OUTLINE OF TESTIMONY

I. The domestic relations provisions of the Retirement Equity Act of 1984 are generally well crafted but require some technical amendments to work more effectively.

II. Under Code Section 414(p)(4), the form of benefit payable to an alternate payee is limited in one special case. There should be no limits on the form of benefits available to alternate payees.

III. Under Code Section 402(a)(9) as amended by H.R. 2110, the taxability of payments to an alternate payee who is a spouse or former spouse is clear. There should be similar clarity about the taxability of payments to other alternate payees. In addition, Code Section 72(m)(10) about pro rata sharing of basis should be conformed to Code Section 401(a)(9).

IV. Under new Code Section 414(p)(9) as added by H.R. 2110, only payments of $3,500 or less would be allowable to an alternate payee before the participant separates from service under certain plans. Retirement plans should have broader authority to pay benefits to the alternate payee before the participant separates from service.

V. Under ERISA Section 206(d)(3)(G), an alternate payee may designate a representative to receive notices about domestic relations orders from the plan. This provision should be expanded to include those individuals who would be alternate payees if the order were found to be qualified.

I. INTRODUCTION

Mr. Chairman and Members of the Committee, I appreciate the opportunity to testify today about H.R. 2110, to make technical corrections to the Retirement Equity Act of 1984 (REA). My name is Steven D. Kittrell and I am testifying in my individual capacity. I am the Chairman of the American Bar Association, Section Of Taxation, Committee on Domestic Relations Tax Problems. I am an attorney with O'Connell & Kittrell in Washington, D.C. and practice in the areas of retirement benefits and domestic relations. I am the author of "The Retirement Equity Act of 1984: Divorce & Pensions," published by Divorce Taxation Education, Inc. My testimony is about the domestic relations provisions of the REA.

The REA created the first federal statutory rules about the treatment of retirement benefits in divorce. The Retirement Equity Act balances the interests of divorcing spouses in dividing retirement benefits with the interests of plan administrators in efficiently operating retirement plans. Overall, the REA does an excellent job of respecting the legitimate concerns of both groups. With one exception noted in part IV of my testimony, I support all of the technical corrections presently contained in H.R. 2110. My testimony is about further technical issues not addressed in H.R. 2110.

The REA includes new statutory terms. An "alternate payee" is the person, usually a spouse or former spouse, who will receive part of the participant's retirement benefits under a domestic relations order. A "qualified domestic relations order" (QDRO) is a state domestic relations order which meets all of the REA requirements.

II. CODE SECTION 414(p)(4): FORM OF BENEFITS FOR THE ALTERNATE PAYEE

Under Code Section 414(p)(4)(A), payments may be made to the alternate payee after the participant reaches early retirement age, even though the participant has not separated from service. (ERISA Section 206(d)(3)(E)). In this special case, a QDRO may not order benefits to be paid in the form of a joint and survivor annuity for the alternate payee and the alternate payee's subsequent spouse.

This limitation on the form of benefit applies only when the participant has reached early retirement age remains employed. An alternate payee may elect a joint and survivor annuity with his or her new spouse in any other instance. There is no reason to have a special rule which applies only when benefits are paid before the participant separates from service after reaching early retirement age.

An alternate payee should be allowed to elect any form of benefit available under the plan. For most purposes, an alternate payee is treated as a participant. The freedom to choose the most appropriate benefit form can be important to a participant or alternate payee.

One reason given for this restriction on joint and survivor annuities is the concern that the alternate payee's benefit then might be the subject of a subsequent QDRO in an action between the alternate payee and the new spouse. I do not believe that this is a valid concern. The alternate payee should be treated as the owner of the benefits for all purposes, including designation of any beneficiary to receive survivor benefits.

I recommend that the restriction on payment of joint and survivor annuities to an alternate payee be eliminated by deleting the parenthetical phrase at the end of Code Section 414(p)(4)(A)(iii). (ERISA Section 206(d)(3)(E)(i)(III)).

III. CODE SECTIONS 402(a)(9), 72(m)(10): TAXATION OF AN ALTERNATE PAYEE

Code Section 402(a)(9) provides that an alternate payee is to be taxed on payments from a retirement plan in the same manner as the participant. H.R. 2110 would amend Code Section 402(a)(9) to limit this rule to an alternate payee who is a spouse or former spouse of the participant. Under the present statute, if payments are paid to a participant's child, the child would be taxable on the payments even if direct payments from the participant would be nontaxable to the child. The amendment in H.R. 2110 solves this problem.

H.R. 2110 should go further to provide clarity about the tax results for alternate payees other than a spouse or former spouse. When payments are made to an alternate payee other than a spouse or former spouse, the entire payment should be taxable to the participant. The participant should be treated as having received the full payment and having transferred part of the payment to the alternate payee. This result would be the most consistent with the economics of the transactions and would avoid having to deal with many special situations in the statute. As to alternate payees other than a spouse or former spouse, a QDRO would be used to fulfill an obligation of the participant. The obligation usually would be the participant's obligation to support the alternate payee. The tax result to the participant and the alternate payee should be the same as if the plan were not involved.

Under Code Section 72(m)(10), an alternate payee is allocated a pro rata share of the participant's basis in the retirement benefits. If Section 402(a)(9) is limited to certain alternate payees, the pro rata allocation in Code Section 72 should be limited to payments which are made to alternate payees who are spouses or former spouses of participants.

I recommend that Section 402 be amended to tax the participant on all payments under a QDRO which are made to any alternate payee other than a spouse or former spouse of the participant. I also recommend that Section 72(m)(10) be conformed with Section 402(a)(9) as amended by H.R. 2110.

IV. CODE SECTION 414(p)(9): PAYMENTS BEFORE SEPARATION FROM SERVICE

H.R. 2110 would add a new Code Section 414(p)(9) which would apply to any plan which is prohibited from paying benefits before a participant terminates employment, usually a defined benefit plan or a cash or deferred plan under Code Section 401(k). Before the participant terminates employment, such a plan could pay benefits to an alternate payee under a QDRO only if the value of the benefits is $3,500 or less.

New Section 414(p)(9) would provide a limited exception to the general Section 401 rules which restrict the timing of payment of benefits. In those cases where the benefit to be paid to the alternate payee would be small ($3,500 or less), the plan could

avoid the future administrative expenses for the alternate payee by making a current payment of the benefits.

The rules should be expanded to allow a plan and an alternate payee to agree that benefits would be paid in a lump sum to the alternate payee whenever the QDRO is issued. If the plan and the alternate payee agree, the current payment of benefits would allow the alternate payee to sever relations with the plan. This would be especially important for small plans where the participant is also the administrator and trustee.

One perceived problem with making current payment to an alternate payee is that the alternate payee would receive benefits before the participant would be able to receive them. This situation has been characterized as an incentive for the parties to divorce in order to obtain benefits at an earlier date. While this potential exists, in my experience the likelihood of a couple taking such actions is very remote.

I recommend that proposed Code Section 414(p)(9) in H.R. 2110 be amended to allow plans and alternate payees to elect jointly to pay the benefits currently in a lump sum to the alternate payee. The alternate payee then could rollover the lump sum into an IRA. The benefits would remain in a qualified retirement plan, although the form of that plan would be changed to an IRA.

V. ERISA SECTION 206(d)(3)(G): DESIGNATION OF A REPRESENTATIVE

Under ERISA Section 206(d)(3)(G)(ii)(III), plan procedures must allow an alternate payee to designate a representative to receive copies of plan notices about a domestic relations order. This rule ensures an alternate payee may be represented by legal counsel with whom the plan must communicate.

ERISA Section 206(d)(3)(G) does not apply before a domestic relations order is determined to be a QDRO. Until the order is determined to be qualified, there is no "alternate payee" under the statute. The most important period of time to a potential alternate payee is the time after the plan administrator receives the order and before the administrator makes a decision about the order's qualification. The potential alternate payee is not guaranteed the right to have a representative at the most crucial time in the process. In contrast, ERISA Section 206(d)(3)(G)(ii)(II) clearly refers to a potential alternate payee as being entitled to notice of the plan procedures about domestic relations orders.

I recommend that ERISA Section 206(d)(3)(G)(ii)(III) be amended to apply to each person who would be entitled to benefits if the domestic relations order is found to be qualified. These persons would have the right to designate a representative to receive communications from the plan.

VI. CONCLUSION

Thank you for the opportunity to testify about technical corrections to the domestic relations provisions of the Retirement Equity Act of 1984. I would be glad to answer any questions about my testimony.

Mr. GUARINI. Mr. Ethan Lipsig.

STATEMENT OF ETHAN LIPSIG, COUNSEL, BAKER INTERNATIONAL CORP., LOCKHEED CORP., NORTHROP CORP., AND TRW

Mr. GUARINI. You have formidable clients.

Mr. LIPSIG. I am here today to testify on behalf of the corporations you mentioned on the proposed technical corrections to the Retirement Equity Act.

While we generally support the proposed corrections, there are a number of provisions which cause us considerable concern. I would like to begin by addressing the domestic relations order provisions, some of which were previously discussed.

The Retirement Equity Act was designed in large part to permit spouses to obtain immediate payment of pension benefits through the divorce decree mechanism. It is incomprehensible to us that the proposed technical corrections bill would subvert the very purpose of REA by disqualifying plans for following such orders.

Large employers want to comply with these orders and we want to comply with them on a timely basis. It makes no sense—there is no sound policy reason—to permit a participant's spouse to get benefits quickly if the participant happens to be in a profit-sharing plan, but to forbid the participant's spouse from getting the benefits quickly if the participant is in a pension plan.

Restrictions on early payment are imposed on some plans to make sure the money is there for retirement. Once plans are required to meet the divorce orders, there is no further need to protect the participant, because the money is going to go to the alternate payee.

We would like the provisions in the bill which prohibit the payment of benefits pursuant to divorce orders exactly reversed.

The second troublesome provision in the domestic relations area relates to the taxation of payees. The Retirement Equity Act is clear: Alternate payees pay the tax. This is perfectly consistent with statute as generally applied to distributions. Code section 402 requires the distributee to pay the tax on distributions. We see no reason for changing prior law.

Although this is not in the technical corrections bill, we think that a minor technical correction should be included in the divorce order provisions, making it possible for plan administrators to agree without court approval to modify a defective order so as to make it qualify.

As the statute is currently written, if an order is defective the only recourse is for the alternate payee to go back to court, and that is cumbersome. We would like to correct defects by agreement.

I would like to turn to what I consider to be one of the more outrageous provisions in the bill, a provision which in fact imposes a penalty tax on people simply because they go back to work and thereby save the benefits that REA was designed to preserve for them.

This provision essentially would tax a person so as to recapture 10-year averaging tax benefits if the person goes back to work within 5 years of termination of employment and thereby saves the uninvested portion of the benefit he or she left behind. We realize the technical basis for the proposal, but think that people should not be penalized for going back to work and saving benefits because that was the very thing REA was designed to make possible.

I would like to turn to class year vesting plans. That is an alternative vesting mechanism authorized by ERISA in lieu of compliance with the regular ERISA rules.

One of the ERISA rules forbade defined contribution plans from forfeiting unvested benefits before a person incurred a 1-year break in service. REA extended that to a 5-year break. Because class year plans had not been subject to the old 1-year rule, they were not subject to the new 5-year rule. Now, after 10 or 12 years during which class year plans were not subject to the ERISA vesting rules, this bill would change that by making class year plans wait for a 5-year break before forfeiting benefits.

The proposed change is not a technical correction. It is a major revision to an alternative vesting system authorized by ERISA, and it should not be enacted at this time in the guise of a mere "technical correction."

I have a number of other comments which I would like to summarize briefly.

This technical corrections bill would impose additional spousal consent requirements for loans and for certain beneficiary designations. The benefit of these spousal consents, we think, would be relatively minor and they would be very burdensome with which to comply at the present time, since every plan, description and consent form would have to be revised to take into account these extra requirements. We would not have objected to the new consent requirements had they been included in REA. We respectfully request they not be added at this time. They are not technical corrections. If added, give us time to comply with them.

By all accounts, the maternity and paternity leave provisions in REA were only included by accident because the 5-year break in service rule was designed to take care of the problem. This technical corrections bill should eliminate the maternity and paternity leave provision.

Finally, we need clarification of the provision in REA which precludes benefits from being immediately distributable except with participant consent. We don't know what that means and we need clarification.

Thank you.

Mr. GUARINI. Thank you.

[The prepared statement follows:]

STATEMENT OF ETHAN LIPSIG ON BEHALF OF LOCKHEED CORP., NORTHROP CORP., BAKER INTERNATIONAL CORP., AND TRW

I. INTRODUCTION

This statement is being made on behalf of four major companies employing more than a quarter of a million workers. While these companies generally support H.R. 2110, which would make technical corrections to the Retirement Equity Act ("REA"), there are a number of provisions in H.R. 2110 which are extremely disturbing and go far beyond being mere "technical" corrections. In addition, a number of needed changes have not been proposed.

Our concerns fall into three categories: (1) substantive changes in law which should be deleted from the bill; (2) technical corrections which have not been proposed but which should be made; and (3) proposed technical corrections which should be adopted in modified form. These three categories are discussed seriatim.

II. SUBSTANTIVE CHANGES THAT SHOULD NOT BE MADE

H.R. 2110 contains a number of substantive changes in the law which are being proposed as mere "technical" corrections. Because of the tremendous impact that these changes will have, we think it is inappropriate for them to be adopted in the context of a technical correction bill without careful consideration of all their ramifications. These provisions are as follows:

(a) *Proposed change to class year vesting.* The most dramatic example of a substantive change in the technical corrections bill is the provision which for the very first time would extend some of ERISA's break in service concepts to class year vesting plans. A "class year" vesting plan is a defined contribution plan under which each year's contribution vests independently. For example, contributions for a given year vest at the end of the fifth following year (this is the maximum vesting period allowable in class year plans). In contrast to the five year maximum allowable under class year plans, a wait of up to fifteen years before benefits fully vest is permitted under conventional vesting provisions. As the quid pro quo for faster vesting, class year plans were not required by ERISA to comply with any of the following vesting rules:

1. Counting hours of service.
2. Counting years of service.
3. Counting break in service years.

4. Counting years before a person became a participant in the plan.
5. Counting service with affiliates.
6. Waiting for a break in service year before forfeiting benefits.
7. Counting prior service after rehire (except if a "parity" break has occurred).

REA modified the ERISA rule which generally prohibited a defined contribution plan from forfeiting benefits until a break in service year had occurred. This modification consisted of prohibiting forfeitures until five consecutive break in service years had occurred. Since class year plans were never subject to the one year ERISA rule, they were not subject to the five year modification of that rule.

The proposed technical corrections bill would for the very first time impose an ERISA break in service rule on class year plans. It would do this by establishing a "break in service" concept for class year plan purposes and would make a class year plan wait for five consecutive break years before it could forfeit an unvested benefit. This change would unquestionably make class year plans more like conventional plans and that is the very reason why this change should not be adopted. Class year plans are supposed to be different from other plans. Because of their shorter vesting requirements, they were exempted from all the ERISA vesting requirements listed above. H.R. 2110 would change all this by making class year plans subject, in effect, to conventional vesting requirements.

The proposed change is also untimely. Employers have spent millions of dollars complying with REA. This one change would require virtually every of the many class year plans in this country to be amended and resubmitted to the Internal Revenue Service and would require summary plan description updates.

In short, the proposed class year vesting rule should not be adopted. It is not a technical correction, it constitutes piecemeal tinkering with a complex statutory scheme and its untimely adoption will be very burdensome.

(b) *Proposed change to the joint and survivor annuity provisions.*—The proposed technical corrections bill would in two ways extend the spousal consent requirements imposed by REA on plans subject to the joint and survivor rules. First, it would require spousal consent to the pledge of plan benefits as security for a participant loan. Second, it would require that spousal consents to waivers of post retirement survivor annuity benefits also include consents to the designation of beneficiaries under the alternative form of benefit chosen (if it provides for a death benefit).

Neither of these two consent requirements would have been particularly objectionable had they been included in REA. However, they were not included in REA and establishment of these two spousal consent requirements at the present time will impose a serious burden on employers. Once again, they will have to amend plans, plan descriptions and administrative forms to comply with these two new requirements.

These new requirements will not provide significant protection to spouses. First, only a very small percentage of the employee population is covered by plans which are subject to joint and survivor requirements and which permit loans. Second, spouses are already required to acknowledge the effect of their consents to waivers of post retirement survivor benefits in order for the consents to be valid. Many employers interpret this acknowledgement requirement to require that the spouse also consent to the alternate form of benefit chosen and the designation of beneficiaries under it. These employers reason that, absent consent to the form actually chosen and the beneficiary designated, it would be hard to prove that the spouse truly understood the effect of his or her consent. Thus, there is no practical need to require that spouses consent to beneficiary designation because many employers already require this anyway.

Our objection to these proposed spousal consent requirements is primarily that they are not timely and that compliance would, therefore, be burdensome. In view of the very limited benefits that would be derived from them, we urge that these requirements be eliminated entirely. However, if these requirements must be enacted, we urge that employers be given ample time to comply with these additional requirements so as not to burden them unduly. For example, compliance might be required at the time a plan is otherwise amended after enactment of this bill, but with a maximum compliance deadline of January 1, 1988.

(c) *Qualified domestic relations orders.*—H.R. 2110 would change two provisions relating to the qualified domestic relations order ("QDRO") rules in REA. The QDRO provisions are widely supported by employers. These rules permit employers and plans to deal with divorce orders and other support decrees in an efficient and equitable fashion. The two technical corrections proposed to the QDRO provisions would seriously erode this benefit.

The first such change is a provision which would make the participant taxable on amounts paid to an alternate payee (other than spouse or former spouse). The clear

and unambiguous rule under REA was that the alternate payee was to be taxed on the distribution whether the alternate payee was a spouse or not.

The proposed change will be difficult to enforce and difficult to explain to participants. Why should they have to pay money on a retirement plan distribution made to someone else? The constructive receipt rules in Section 402 of the Internal Revenue Code (governing taxation of pension benefits) were repealed a number of years ago and Section 402 currently imposes tax liability on "any distributee" of benefits. Tax liability should follow the money and this change to REA should not be made.

The second change to the QDRO rules is even more troublesome. This rule would prohibit a plan from complying with a qualified domestic relations order to the extent it required more than a de minimis distribution before the amount could otherwise be properly paid to the participant. Thus, until an employee reaches retirement age, for example, a pension plan could not follow a QDRO requiring that payments be made to a spouse or child, no matter how needy the spouse or child was. There simply is no sound policy reason for prohibiting a plan from complying with a QDRO just because the distribution would have been premature if it had been made to the participant. This provision would make spousal rights dependent on the quirk of whether the participant was covered by a profit-sharing or stock bonus plan (which can make distributions relatively freely) or by a PAYSOP, cash or deferred or pension plan (which are subject to premature withdrawal restrictions).

It is clearly in the interests of spouses and dependents as well as in the interest of employers that they be entitled freely to follow QDRO's without regard to the particular withdrawal restrictions imposed on plan participants. Accordingly, we urge that Section 2(c)(4)(A)(v) of H.R. 2110 be revised by eliminating subparagraphs (B) and (C) and by extending the general rule in subparagraph (A) to cover all plans, including PAYSOPs.

(d) *Penalty for rehire.*—Section 2(A)(2) of the proposed technical corrections bill would impose a potentially severe penalty on individuals who go back to work for a former employer. This provision is totally inconsistent with the most basic objective of REA, which was to make it possible for former employees to return their employers and thereby preserve benefits that they had previously earned.

Under this provision, if an individual terminates employment before his or her entire benefit is vested and receives a lump sum distribution which the individual elects to have taxed under the ten year averaging method and that individual thereafter returns to work for the employer before incurring five break in service years and accrues more vesting credit, the employee has to pay a recapture tax equal to the tax benefit the employee received by claiming ten year averaging on the prior distribution.

Under current law, a somewhat analogous rule exists, but an individual must return to work within about one year in order for it to apply. See Temp. Treas. Reg. § 11.402(e)(4)(A)–1. The Internal Revenue Code itself has no "recapture" rule similar to the proposed five year rule.

The rules relating to taxation of participant distributions are among the most complex provisions which individuals ever have to deal with under the tax laws. The proposed change would add yet another new layer of complexity and could prove a severe impediment to rehiring former employees. For example, an individual might have received ninety-five percent of his or her account in connection with an earlier termination of employment and be subject to a very large recapture tax penalty if the individual returns to work within five years. It may be less expensive for the individual not to return to work than to pay the tax. Moreover, employees who do return to work may not have the cash to pay the tax.

The question then is, why is this provision sound and necessary? This provision essentially has its roots in an unreasonable IRS interpretation of the lump sum distribution requirements of Code Section 402(e). Those provisions require that an employee have received the "balance to his credit" under a plan to qualify for special tax treatment. When ERISA extended the time for forfeitures of unvested benefits to one year after termination of employment, the IRS should have interpreted "balance to the credit" to mean the vested balance. However, the IRS insisted on taking the unvested balance into account, unless it ultimately was forfeited.

Under the ERISA rules, the IRS position, although unreasonable, did not cause significant problems since unvested balances were forfeitable within a relatively short period of time after termination of employment. Under REA, however, forfeitures may not occur for a minimum of about five years and this makes the IRS position, which was always unreasonable, suddenly very burdensome. It is quite ironic that provisions which were designed to liberalize ERISA rules to permit people to return to work to save benefits would serve as a basis for imposing a penalty for returning to work.

For all of the foregoing reasons, we strongly urge that this penalty provision be deleted in its entirety. Ideally, this provision should be replaced by one which would eliminate any kind of recapture possibility by defining the term "balance to the credit" in Section 402(e) of the Internal Revenue Code to mean the "vested balance to the credit." If such a liberal rule is not possible, a reasonable compromise would be to apply recapture if the individual is rehired before the due date for filing his or her tax return for the year in which the distribution occurred.

III. TECHNICAL CORRECTIONS WHICH ARE NOT IN THE BILL BUT WHICH SHOULD BE MADE

Three necessary technical corrections have not been included in H.R. 2110. The first is clarification of the language in the sections in ERISA and the Internal Revenue Code which were amended by REA to establish a new requirement that benefits cannot be "immediately distributable" without participant consent. The second is elimination of the maternity/paternity provisions in REA. The third is to permit domestic relations orders to be turned into QDRO's by means of stipulated modifications.

(a) *The "immediately distributable" requirement.*—REA included in ERISA and the Code a provision which makes it illegal for benefits to be "immediately distributable" without a participant's consent unless the benefits are de minimis in amount. REA did not modify the provisions which establish maximum time limits by which benefits must be paid. Accordingly, most employers interpret the "immediately distributable" language as simply precluding mandatory benefit commencement before a participant's attainment of normal retirement age or death or pursuant to a QDRO. Employers, however, are concerned that this provision might also be interpreted as forbidding plans to make all distributions in lump sums. Another possible reading of the provision is that it is merely intended to prohibit lump sum distributions which commence before the participant's normal retirement age, death or pursuant to a QDRO. Since this provision is ambiguous, it should be clarified. We recommend that the provision be clarified so that it only prohibits mandatory benefit commencement before normal retirement age or death except pursuant to a QDRO.

(b) *Maternity/paternity leaves.*—By all accounts, the maternity/paternity leave provisions of REA were included in it by mistake. Apparently, there were two alternative approaches being considered for giving women greater flexibility to leave an employer and return to work without losing benefits. One of the alternatives was a extension of the break in service year rules to require a minimum absence of about five years. The other alternative was the maternity/paternity leave provisions. When the five year break rule was adopted (clearly the more liberal rule), the maternity/paternity leave provisions apparently were retained by accident. This leads to anomalous results. For example, if an individual gives birth to a child and leaves work to take care of the child, the individual can take about six years off before losing benefits. For any other absence, the individual can only have five years off. Besides being anomalous, the maternity/paternity leave provisions are just one additional unneeded and burdensome protective measure with which employers and employees must deal. It should be eliminated at this time.

(c) *Stipulated modifications to QDRO's.*—As currently written, the QDRO provisions of REA require that a court order comply with a laundry list of technical requirements. Because family law specialists are not expert in retirement benefit law, it will be very uncommon for domestic relations orders to comply with all of the new statutory requirements, at least if past practices are any indication of the future. Frequently, the deficiencies in an order can be easily rectified, such as by the simple expedient of clarifying which plan is required to pay the distribution. As the QDRO provisions currently exist, a plan could be disqualified for following a defective QDRO which is modified by mutual agreement of the parties to cure the deficiency. This means that prudent plan administrators will require that alternate payees go back to court to get court approval of needed modifications before following the orders. This is inconsistent with the spirit of REA and adds an additional burden on plan administrators and alternate payees alike. Accordingly, the QDRO provision should be modified to include a provisions which would permit defects in a QDRO to be rectified by agreement between the plan administrator and the alternate payee, at the option of the plan administrator. Participant consent should not be required unless the corrections to the order could in any way affect the participant's right to benefits. Such a change would make the QDRO provisions a great deal easier with which to live and help them achieve their purposes.

IV. TECHNICAL CORRECTIONS WHICH SHOULD BE MODIFIED

Section 2 of the proposed technical corrections bill would permit a surviving spouse to consent to a beneficiary designation after the participant's death without tax liability, but only if the participant died after enactment of REA but before it became effective. There is no reason why a spouse should not be permitted to consent to a beneficiary designation without tax consequences after the death of the participant in every pre-retirement death situation. This is particularly necessary in defined contribution plans since relatively few defined benefit plans provide pre-retirement death benefits other than surviving spouse benefits. In defined contribution plans, the almost universal rule is that, on a participant's death, his or her account vests and is paid to his or her designated beneficiary. By allowing post-death beneficiary consents, spouses will be protected in that they need not consent until the last possible minute, when their personal circumstances will be clearer. In fact, many employers specifically make spousal consent revocable just for this purpose. For all these reasons, the provision in the technical corrections bill which limits tax-free, post-death spousal consents to those made in a short window period before the effective date of REA should be broadened to apply to all beneficiary consents made in pre-retirement death cases, whether before or after the effective date of REA.

Mr. GUARINI. Mr. Barnes, Mr. Harry James, Mr. James O'Brien. Are each of you going to testify?

Mr. BARNES. Yes, sir, very briefly.

Mr. GUARINI. Mr. Barnes.

STATEMENT OF RUSSELL M. BARNES, SENIOR VICE PRESIDENT AND CHIEF OPERATING OFFICER, PAN AM WORLD SERVICES, INC., ACCOMPANIED BY PETER DUGRE, COUNSEL, HARRY JAMES, AND JAMES E. O'BRIEN

Mr. BARNES. I am Russell M. Barnes, senior vice president and chief operating officer of Pan Am World Services, Inc.

I would like to thank you and the committee for affording me the opportunity to testify today on the need to make technical corrections to the Tax Reform Act of 1984 to restore tax-free standby flight benefits to World Services employees.

Accompanying me today, Mr. Chairman, is Peter Dugre, our general counsel. Also accompanying me are James O'Brien and Harry James, who are, respectively, a World Services retiree and a World Services employee stationed overseas. These last two individuals are among those seriously affected by unavailability of tax-free flight benefits.

I have prepared a detailed written memorandum regarding the necessary amendment, and I request that the memorandum be included in the record.

Our unions support the amendment, and I understand they will be submitting written statements for the record.

I would now like to address briefly the high points.

The proposal we support has been introduced by Mr. Stark as H.R. 528. It has over 80 sponsors in the House, including 15 on this committee.

The Tax Reform Act of 1984 provides new rules governing fringe benefits, effective January 1, 1985. These rules expressly sanction the long-standing practices of the airline industry to provide no-additional-cost services, such as standby flight benefits, to employees without taxation.

However, the 1984 act imposes a requirement that, to be eligible for this tax-free treatment, the employee must be employed in the same line of business as that in which the service is provided.

For example, an employee of an airline could receive standby flight benefits on a tax-free basis only if he is employed in the airline line of business, not if he works in a hotel which is owned by the airline.

For many years, Pan Am World Airways, Inc., has maintained an affiliate, World Services, which performs airline, airport, aerospace, and related services for others on a contract basis. Most of the World Services employees are or were on the Pan Am payroll but have been detailed to World Services.

These employees arguably may not be in the airline line of business, and Pan Am regretfully terminated their standby flight benefits when the 1984 act took effect. H.R. 528 would waive this line of business restriction with respect to World Services for persons employed on or before September 12, 1984.

Many employees of World Services chose that company—or Pan Am, from which they are on detail—years ago because nontaxable standby air travel benefits were materially important to them. For decades, significant career and personal decisions have been made based upon continued eligibility for these benefits.

Many of the World Services employees, in fact, have formerly performed services for Pan Am but were detailed to the subsidiary without any contemplation that their ability to use standby air travel benefits would be endangered.

These individuals are now in a position where they cannot move on to comparable employment elsewhere or replace those benefits. This is especially true of retirees, who are irreparably injured.

For example, an individual who worked for Pan Am in the airline line of business for 30 years, then accepted transfer at Pan Am's request to World Services for a few months, and retired in 1983 would be ineligible for tax-free standby flight benefits because he would not be a Pan Am retiree. This is so even though the 1984 Act was passed after he retired.

Similarly, an individual with many years of service to Pan Am, but who is now on detail to World Services, would also be denied retiree benefits in the future, as well as current benefits while he works for World Services.

Also irreparably harmed are employees who accepted foreign assignments before the 1984 act in anticipation of using their flight benefits to send their children to schools in the United States or return home themselves to visit their families during the time they are assigned overseas. Without standby flight benefits, these employees are burdened by substantial costs unanticipated at the time they accepted their assignments.

The proposal is narrowly tailored to provide relief only to those entitled to it. Only individuals employed on or before September 12, 1984, would be benefited. Subsquently hired employees would not be eligible.

Moreoever, over the course of time, the benefited group will decrease in size through attrition. In this regard, the proposal is much more limited in scope than the accommodation made in the 1984 act for nonretail employees entitled to retail store discounts.

The retail store rule applies to all employees of an affiliate, including future employees, as long as employees of the affiliate were

entitled to an employee discount on October 5, 1983. Thus, the retail store rule will continue in force indefinitely.

Pan Am's proposal, in contrast, is self-limiting and will phase itself out automatically through attrition of the group of covered employees.

Pan Am cannot solve the problem of its World Services employees by electing to be subject to the excise tax under code section 4977. The 1984 act provides that the line of business limitation may be waived if the employer elects to be subject to this tax.

The tax is based on the value of no-additional-cost services and qualified employee discounts provided to all employees of the Pan Am group, including those working in the airline line of business, retirees, and dependents.

Pan Am has some 30,000 employees, while World Services has only about 7,500. The excise tax imposed, should the election be made, would far exceed the entire value of the travel provided to World Services employees.

In this regard, the excise tax mechanism plainly is technically deficient. Because the excise tax takes into account the value of benefits to all employees, including those who are in the airline line of business and concededly are entitled to exclude the value of the benefits from income, the tax would be totally out of proportion to the benefits made available to employees outside the airline line of business.

The excise tax mechanism is especially ill-suited to companies like Pan Am, the bulk of whose employees may receive nontaxable benefits without the election. In contrast, an employer which had only a low proportion of employees who qualified for benefits under the appropriate line of business could elect to extend benefits to his other employees at a relatively lower additional cost.

Quite apart from the economic burdens described above, which Pan Am cannot afford, an election to be subject to the excise tax would impose a serious administrative burden on Pan Am.

Moreover, correct valuation of employees' special low-priority standby status is certain to present many difficult issues and may result in protracted audit disputes between Pan Am and the Internal Revenue Service, neither of which organizations should be asked to devote scarce resources to those matters.

Mr. Chairman, all of the employees of World Services join with me in urging you to include in the Technical Corrections Act of 1985 a provision to permit employees who worked for World Services on or before September 12, 1984, to continue to be eligible for standby air travel benefits on a tax-free basis.

[The prepared statement follows:]

STATEMENT OF RUSSELL M. BARNES, SENIOR VICE PRESIDENT AND CHIEF OPERATING OFFICER, PAN AM WORLD SERVICES, INC.

Mr. Chairman, I am Russell M. Barnes, Senior Vice President and Chief Operating Officer of Pan Am World Services, Inc. I would like to thank you and the Committee for affording me the opportunity to testify today on the need to make technical corrections to the Tax Reform Act of 1984 to restore tax-free standby flight benefits to World Services employees. Accompanying me today, Mr. Chairman, is Peter Dugre, our General Counsel. Also accompanying me are James O'Brien and Harry James, who are respectively a World Services retiree and a World Services employ-

ee stationed overseas. These last two individuals are among those seriously affected by unavailability of tax-free flight benefits.

I have prepared a detailed written memorandum regarding the necessary amendment, and I request that that memorandum be included in the record. Our unions support the amendment and, I understand they will be submitting written statements for the record. I would now like to address briefly the high points.

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The Tax Reform Act of 1984 provides new rules governing fringe benefits, effective January 1, 1985. These rules expressly sanction the long-standing practice of the airline industry to provide no-additional-cost services, such as standby flight benefits, to employees without taxation. However, the 1984 Act imposes a requirement that, to be eligible for this tax-free treatment, the employee must be employed in the same "line of business" as that in which the service is provided. For example, an employee of an airline could receive standby flight benefits on a tax-free basis only if he is employed in the airline line of business, not if he works in a hotel which is owned by the airline.

For many years, Pan American World Airways, Inc., has maintained an affiliate, World Services, which performs airline, airport, aerospace and related services for others on a contract basis. Most of the World Services employees are or were on the Pan Am payroll but have been detailed to World Services. These employees arguably may not be in the airline "line of business," and Pan Am regretfully terminated their standby flight benefits when the 1984 Act took effect. H.R. 528 would waive this "line of business" restriction with respect to World Services for persons employed on or before September 12, 1984.

Many employees of World Services chose that company (or Pan Am, from which they are on detail) years ago because nontaxable standby air travel benefits were materially important to them. For decades, significant career and personal decisions have been made based upon continued eligibility for these benefits. Many of the World Services employees, in fact, have formerly performed services for Pan Am but were detailed to the subsidiary without any contemplation that their ability to use standby air travel benefits would be endangered. These individuals are now in a position where they cannot move on to comparable employment elsewhere or replace these benefits.

This is especially true of retirees, who are irreparably injured. For example, an individual who worked for Pan Am in the airline line of business for 30 years, then accepted transfer at Pan Am's request to World Services for a few months, and retired in 1983 would be ineligible for tax-free standby flight benefits because he would not be a Pan Am retiree. This is so even though the 1984 Act was passed after he retired. Similarly, an individual with many years of service to Pan Am, but who is now on detail to World Services, would also be denied retiree benefits in the future, as well as current benefits while he works for World Services.

Also unexpectedly and irreparably harmed are employees who accepted foreign assignments before the 1984 Act in anticipation of using their flight benefits to send their children to schools in the United States or return home themselves to visit their families during the time they are assigned overseas. Without standby flight benefits, these employees are burdened by substantial costs unanticipated at the time they accepted their assignments.

The proposal is narrowly tailored to provide relief only to those entitled to it. Only individuals employed on or before September 12, 1984, would be benefited. Subsequently hired employees would not be eligible. Moreover, over the course of time, the benefited group will decrease in size through attrition. In this regard, the proposal is much more limited in scope than the accommodation made in the 1984 Act for nonretail employees entitled to retail store discounts. The retail store rule applies to all employees of an affiliate, including future employees, as long as employees of the affiliate were entitled to an employee discount on October 5, 1983. Thus, the retail store rule will continue in force indefinitely. Pan Am's proposal, in contrast, is self-limiting and will phase itself out automatically through attrition of the group of covered employees.

Pan Am cannot solve the problem of its World Services employees by electing to be subject to the excise tax under Code section 4977. The 1984 Act provides that the "line of business" limitation may be waived if the employer elects to be subject to this tax. The tax is based on the value of no-additional-cost services and qualified employee discounts provided to all employees of the Pan Am group, including those working in the airline line of business, retirees, and dependents. Pan Am has some 30,000 employees, while World Services has only about 7,500. The excise tax im-

posed, should the election be made, would far exceed the entire value of the travel provided to World Services employees.

In this regard, the excise tax mechanism plainly is technically deficient. Because the excise tax takes into account the value of benefits to all employees, including those who are in the airline line of business and concededly are entitled to exclude the value of the benefits from income, the tax would be totally out of proportion to the benefits made available to employees outside the airline line of business. The excise tax mechanism is especially ill-suited to companies like Pan Am, the bulk of whose employees may receive nontaxable benefits without the election. In contrast, an employer which had only a low proportion of employees who qualified for benefits under the appropriate line of business could elect to extend benefits to his other employees at a relatively lower additional cost.

Quite apart from the economic burdens described above, which Pan Am cannot afford, an election to be subject to the excise tax would impose a serious administrative burden on Pan Am. Moreover, correct valuation of employees' special low-priority standby status is certain to present many difficult issues and may result in protracted audit disputes between Pan Am and the Internal Revenue Service, neither of which organizations should be asked to devote scarce resources to those matters.

Mr. Chairman, all of the employees of World Services join with me in urging you to include in the Technical Corrections Act of 1985 a provision to permit employees who worked for World Services on or before September 12, 1984 to continue to be eligible for standby air travel benefits on a tax-free basis.

STATEMENT OF JAMES E. O'BRIEN, RETIREE, PAN AM WORLD SERVICES, INC.

My name is James E. O'Brien and I currently reside in Florida. I'm now retired but worked for Pan American World Airways for 35 years. The first 12 years, beginning in late 1946, I operated a Ground Control Approach radar for the airline at Gander, Newfoundland. Then in early 1959 I was transferred to Pan Am's Guided Missiles Range Division at Cape Canaveral as an Aircraft Controller. Subsequently, I was promoted to a Test Operations Controller. In this job I was responsible for calling up all Range resources in support of missile tests, including the manned Mercury and Gemini programs. In 1979, I was detailed to Pan Am World Services and in May of 1981 I retired at age 66.

This law was passed three years after I retired. I had no way to know when I accepted my World Services' assignment, after so many years with Pan American, that my family and I would be affected so adversely.

Reduced fare standby travel privileges were an important consideration in my staying with Pan Am over the years. We traveled extensively because of family medical problems while I was still working. Since I have retired, my wife and I travel to visit our children who are located in this country and Canada. My plans for the future included such trips. However, without standby travel benefits, our finances now make this quite impossible. Further, we certainly would not have planned our retirement home so distant from our children. I had no idea that this important benefit for which I had been eligible would suddenly become taxable and be taken from me. In fairness, I ask you to make it possible for my family and I to receive my retirement benefits.

STATEMENT OF HARRY JAMES, BASE MANAGER, ANTIGUA, PAN AM WORLD SERVICES, INC.

My name is Harry James and I am 57 years of age. For the past 27 years I have worked for Pan American World Airways. Since 1979 I have been detailed to Pan Am World Services on a contract to operate and maintain downrange tracking stations on the U.S. Air Force Eastern Test Range. This Range extends from Cape Canaveral to the remote island of Ascension in the south Atlantic Ocean. I am presently the Base Manager at the tracking station on Antigua.

I am proud to have participated in a program that was of national interest and which would open a new era for the airline industry of tomorrow with flights into space and to other planets. During all these years of hardship on remote islands and separation from my family due to unavailability of adequate housing and limited schooling for my three children, I relied upon the two or three times a year I could return home to my wife, parents, and children utilizing my standby travel benefit privilege. In addition, like many other fellow employees, I was relying upon standby travel benefits after retirement for my wife and I. The Deficit Reduction Act resulted in the elimination of standby travel benefits for myself and employees similarly

situated and created unforeseen problems to all those who made career decisions and sacrifices for many, many years. I do believe that the effect the Deficit Reduction Act created was unintentional; therefore, I plead with you, for fairness sake, to approve the proposed amendment that would provide relief and return these benefits at least to those employees who were on the Company's payroll on or before September 12, 1984.

Transitional Rule for Nontaxable Air Travel Benefits of Airlines

BACKGROUND

The Tax Reform Act of 1984 (the "Act") establishes new rules for the tax treatment of employee fringe benefits. Generally, the Act permits exclusion from an employee's income of the value of "no-additional-cost" services, i.e., services for which the employer incurs no additional cost and which are offered for sale to customers in the ordinary course of the line of business in which the employee works. Employers may also offer qualified employee discounts of no more than 20 percent of the value of services, even where the employer incurs costs (e.g., forgone revenue). Under these rules, an affiliated group of corporations operating an airline can offer free or reduced cost standby air transportation to its airline employees but cannot offer this benefit on a nontaxable basis to other employees in the group. (Non-airline employees can be included only if the group pays a non-deductible excise tax equal to 30 percent of the amount by which the benefits to all its employees, retirees, and their dependents exceed one percent of their compensation.)

Pan American World Airways, Inc. ("Pan Am"), operates an airline. An affiliate, Pan Am World Services, Inc. ("World Services"), engages in a variety of contract services, many of which involve aviation, airport, and aerospace services, but not the actual operation of an airline. World Services employees have been eligible for free or reduced cost standby travel on Pan Am for decades, but arguably this benefit would be taxable to them under the Act, and Pan Am regretfully terminated their eligibility for the benefit when the Act took effect.

PROPOSAL

Under the proposal, an individual who on September 12, 1984, was performing services for one member of a corporate group and was eligible for nontaxable air travel benefits provided by a corporate affiliate would continue to be eligible to treat the benefits as nontaxable if two conditions are met. Firstly, the primary business of the group as of September 12, 1984, must be air transportation of passengers. Secondly, at least 50 percent of the persons performing services on September 12, 1984, for the member of the group for which the individual is currently performing services must have been employees of or previously have performed services for the group's airline affiliate.

The proposal has been introduced as H.R. 528 and S. 120.

REASONS FOR PROPOSAL

1. The affected individuals have relied on the continuing availability of nontaxable standby air travel benefits. In many cases, this expectation has resulted in these individuals making personal and career decisions which cannot now be changed, particularly in the case of retirees and employees assigned abroad. Individuals who formerly were employed in the airline line of business have been transferred to other lines of business, only to discover that in their future employment inthe group and in their retirement they will be ineligible for tax-free treatment. This result is inequitable and unjust to these individuals.

2. The proposal provides relief only to individuals who were receiving standby air travel benefits on September 12, 1984. Future employees would not benefit.

3. Pan Am cannot solve the problem by electing to be subject to the excise tax because the tax would be computed based on benefits provided to all employees, retirees, and dependents in the group, including those working for the airline. Because the vast majority of the group's employees are in the airline business, even modest use of the standby air travel benefit would result in an excise tax which would far exceed the total value of benefits provided to World Services employees. This illogical and technically flawed excise tax mechanism ought not to serve as the only avenue of relief insituations such as Pan Am's, where the group which concededly is eligible for the tax-free benefit (the airline employees) is far greater in size than the other employees sought to be included.

4. Pan Am also is unable to make the excise tax election because the administrative costs of accounting for air travel for Pan Am's many employees, retirees, and their dependents would impose an unconscionable burden.

5. As a result of the worldwide recession, high fuel costs, airline deregulation, and other factors, Pan Am has suffered significant losses over the last several years. This proposal would help Pan Am now but would be capped at present levels and would automatically phase out over time through attrition.

6. The proposal would not set a precedent; the Act already includes special relief for employees of affiliates of retail stores. Moreover, that relief applies to current and future employees of the retail store affiliates; Pan Am's proposal would apply only to persons who were receiving benefits on September 12, 1984.

Transitional Rule for Nontaxable Air Travel Benefits of Airlines

BACKGROUND

The Tax Reform Act of 1984 provides new rules for the treatment of employee fringe benefits. As a general rule, the value of certain types of employer-provided benefits described in section 132 of the Internal Revenue Code of 1954 (the "Code") may be excluded from the employee's income. Benefits not described in section 132 (other than those for which other statutory treatment is prescribed) are expressly made includable in the employee's income under Code section 61(a)(1).

Among the benefits which may be excluded under section 132 are those which qualify as a "no-additional-cost service," which is defined by Code section 132(b) to mean any service provided by an employer to an employee for use by such employee if—

> (1) such service is offered for sale to customers in the ordinary course of *a line of business of the employer in which the employee is performing services,* and
>
> (2) the employer incurs no substantial additional cost (including foregone revenue) in providing such service to the employee (determined without regard to any amount paid by the employee for such service). [Emphasis added.]

"No-additional-cost" services include free standby air transportation provided by an airline for its employees. However, because of the "line of business" limitation, only employees working in the airline line of business qualify for tax-free treatment of the benefit. Employees in other lines of business of the employer do not qualify. This is illustrated in the legislative history:

> Under this limitation, for example, an employer which provides airline services and hotel services to the general public is considered to consist of two separate lines of business. As a consequence, the employees of the airline business of the employer may not exclude the value of free hotel rooms provided by the hotel business of the employer, and vice versa. The purpose of the line of business limitation is to avoid, to the extent possible, the competitive imbalances and inequities which would result from giving the employees of a conglomerate or other large employer with several lines of business a greater variety of tax-free benefits than could be given to the employees of a small employer with only one line of business. Thus, small businesses will not be disadvantaged in their ability to compete with large businesses providing the same goods or services, and employees of small business will not be disadvantaged in comparison to employees of multifaceted businesses, in terms of receiving tax-free economic benefits. H.R. Rep. No. 432, 98th Cong., 2d Sess. 1594–95 (1984).

Additionally, employers may offer "qualified employee discounts" on goods and services even where the employer incurs a substantial additional cost. In the case of services, Code section 132(c)(1)(B) provides that the discount qualifies for exclusion from income to the extent that it does not exceed "20 percent of the price at which the services are being offered by the employer to customers." As is the case with no-additional-cost services, Code section 132(c)(4) imposes a "line of business" limitation on the types of services which may be offered at a discount to any particular employee.

The Act further provides that all employees of a controlled group of corporations are generally to be treated as employed by a single employer. Additionally, certain retired employees and members of employees' families are treated as employees eligible to exclude the value of benefits from income.

The "line of business" limitation does not apply if the employer elects to subject itself to a nondeductible excise tax under Code section 4977 and, as of January 1, 1984, substantially all of the employees of the employer were entitled to no-additional-cost services or qualified employee discounts in one of the employer's lines of

business. The excise tax is equal to 30 percent of the excess of the value of no-additional-cost services and qualified employee discounts to all employees, retirees, and their dependents over one percent of the amount of taxable compensation of those employees. Thus, the value of benefits provided to employees who are working in the correct (e.g., airline) line of business (and retirees and dependents) is included in computing the amount subject to the excise tax, as well as the value of benefits provided to employees, retirees, and dependents in other lines of business.

PAN AM WORLD SERVICES, INC.

Pan American World Airways, Inc. ("Pan Am") operates an airline and its employees are generally eligible for free air transportation on a standby basis which would qualify as a no-additional-cost service. Additionally, Pan Am employees can purchase tickets for travel on Pan Am at a discount. An employee who does so is boarded in preference to certain other standby passengers. Because Pan Am might forego revenue, this benefit must qualify as a qualified employee discount.

Pan Am World Services, Inc. ("World Services") is the only major affiliate of Pan Am.[1] On a contract basis for other companies or government entities, World Services performs airline, airport, aerospace, base support, community, and engineering services. While these services in particular relate to a variety of airline, airport, and aerospace support functions, such as maintenance and passenger services, World Services does not itself operate an airline.

Most of the individuals performing services for World Services were hired by Pan Am and are on the Pan Am payroll but have been detailed to World Services operations on an indefinite basis. Employees detailed to World Services are eligible for standby free air transportation on Pan Am (including standby free travel on other airlines under reciprocal written agreements) to the same extent as Pan Am employees. Employees of World Services not on detail from Pan Am are eligible for lesser privileges. These individuals must pay for a portion of the cost of their flights and are ineligible for Pan Am's reciprocal arrangements with other airlines. Pan Am has approximately 30,000 employees, while World Services has approximately 7,500.

DESCRIPTION OF PROPOSAL

Under the proposal, an individual who on September 12, 1984 (the date the proposal was first introduced in the 98th Congress), was performing services for one member of a corporate group, and who was eligible for no-additional-cost services in the form of air transportation provided by another member of the same corporate group, would be treated as in the same line of business (for purposes of the no-additional-cost service and qualified employee discount provisions) as the group's airline affiliate if two conditions are met. Firstly, the primary business of the group as of September 12, 1984, must be air transportation of passengers. Secondly, at least 50 percent of the individuals performing services on that date for the member of the corporate group for which the individual is performing services must have been employees or previously have performed services for the group's airline affiliate. Thus, individuals who were performing services (including detailed employees) for World Services on September 12, 1984, could continue to exclude from income the value of free or reduced cost standby air transportation provided to them by Pan Am.

The proposal was introduced during the 98th Congress in the House of Representatives as H.R. 6231 and in the Senate as S. 2995. In the current Congress, the proposal has been introduced in the House of Representatives as H.R. 528 and in the Senate as S. 120.

REASONS FOR PROPOSAL

1. *Employees justifiably relied on the continuing availability of nontaxable standby air travel.*—Many employees of World Services chose that company (or chose Pan Am, from which they are on detail) years ago because nontaxable standby air travel benefits were materially important to them. For decades, significant career and personal decisions have been made based upon continued eligibility for these benefits. Many of the World Services employees, in fact, have formerly performed services for Pan Am but were detailed to the subsidiary without any contemplation that their ability to use standby air travel benefits would be endangered.

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[1] Previously, World Services was a wholly owned subsidiary of Pan Am. Pursuant to a plan of reorganization which received a favorable ruling from the Internal Revenue Service, Pan Am and World Services became brother-sister subsidiaries within an affiliated group.

These employees are now in a position where they cannot move on to comparable employment elsewhere or replace these benefits. This is certainly true as regards retirees of World Services, who are irreparably injured. For example, an individual may have worked for Pan Am for many years and, shortly before retirement, agreed to a transfer to World Services. That individual would not qualify as a retiree of Pan Am and would be ineligible for tax-free standby air travel benefits, even if he retired before passage of the 1984 Act. Similarly, an individual who worked for many years for Pan Am and is currently working for World Services would be ineligible for such benefits currently and upon retirement.

The 1984 Act's limitations have also had an unexpected and irreparable effect on World Services employees who accepted assignments overseas prior to passage of the Act. These individuals are in many cases now no longer able to return home to visit their families. If they were accompanied by their families, they are often unable to send their children to U.S. schools as they had planned.

The Act's legislative history indicates that the "line of business" limitation was included to achieve fairness between small businesses and conglomerates. No consideration was given, however, to fairness to employees who had sacrificed other career and personal opportunities in reliance on the standby air travel benefit. These individuals will now be disadvantaged compared with airline employees, who are similarly situated but may retain the standby air travel benefit.

Moreover, the narrow focus of the Act on competitive equity as to this one point is misguided in Pan Am's situation. As an international air carrier, Pan Am must compete against foreign airlines which are heavily subsidized by their governments.

The obvious solution to affording competitive equity as between large and small companies while not defeating the legitimate expectations of employees who relied on the air travel benefit is to permit only those employees in non-airline lines of business who received the benefit on September 12, 1984, to continue to receive the benefit. Through attrition, large companies will be brought into the same position as small ones. No employee will receive the benefit who did not legitimately rely on the expectation that he would receive the benefit. Nevertheless, those who did legitimately rely would not have their expectations unjustly disappointed.

2. *The proposal applies only to individuals eligible for the benefit on September 12, 1984.*—As just noted, only individuals outside the airline line of business receiving the standby air travel benefit on September 12, 1984, would be entitled to continue to exclude the value of that benefit from income. Subsequently hired employees would not be eligible. Thus, the proposal is narrowly tailored to provide relief only to those entitled to it. Moreover, over the course of time, the benefited group will decrease in size through attrition. In this regard, the proposal is much more limited in scope than the accommodation made for non-retail employees entitled to retail store discounts (see point 6, below).

3. *Pan Am cannot solve the problem by electing to be subject to the excise tax.*—Pan Am cannot solve the problem of its World Services employees by electing to be subject to the excise tax under Code Section 4977. The tax is based on the value of no-additional-cost services and qualified employee discounts provided to all employees of the Pan Am group, including those working in the airline line of business, retirees, and dependents. Pan Am has some 30,000 employees, while World Services has only about 7,500. The excise tax imposed, should the election be made, would far exceed the entire value of the travel provided to World Services employees.

Because the excise tax takes into account the value of benefits to all employees, including those who are in the airline line of business and concededly are entitled to exclude the value of the benefits from income, the tax would be totally out of proportion to the benefits made available to other employees. The excise tax mechanism is especially ill-suited to companies like Pan Am, the bulk of whose employees clearly may receive nontaxable benefits without the election. In contrast, an employer which had only a low proportion of employees who qualified for benefits under the appropriate line of business could elect to extend benefits to his other employees at a relatively lower additional cost.

For example, assume that an employer has 1,000 employees with average annual compensation of $20,000. Each employee receives an average of $600 worth of no-additional-cost services annually for which no charge is made. If the employer elects to be subject to the tax, the amount of tax would be $120,000. [2] Suppose that 850 of

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[2] Benefits = 1,000 × $600 = $600,000. 1 percent of compensation = 1,000 × $20,000 × 1% = $200,000. Tax = ($600,000 − $200,000) × 30 percent = $120,000.

the employees are in the correct line of business and could exclude the value of the benefits from income in any event. The amount of additional benefits made nontaxable by the election is 150 × $600 = $90,000. The amount of tax far exceeds the entire value of the additional nontaxable benefits ($120,000/$90,000 = 133%). Suppose conversely that only 150 employees are in the correct line of business to exclude the value of the benefits in any event. The value of the additional benefits made nontaxable by the election is much greater than the tax. (850×$600=$510,000. $120,000/$510,000=24%.)

The results illustrated above are illogical. The cost of the excise tax is reasonable, compared to the added benefits provided, only if almost no employees are in the correct line of business; if almost all employees would qualify in any event and only a few would be helped by the election, as is the case with Pan Am, the cost is prohibitive. Logic would dictate the opposite result. Congress ought not to make the excise tax the only avenue of relief for a company such as Pan Am where only a small proportion of employees may be outside the relevant line of business. Additional relief such as that which would be provided by the proposal is essential.

4. *The excise tax election would impose a serious administrative burden on Pan Am.*—Quite apart from the economic burdens described above, which Pan Am simply cannot afford, an election to be subject to the excise tax would impose a serious administrative burden on Pan Am. At present, Pan Am's procedures for standby employee air travel are simple and informal, and no permanent records are kept. In order to calculate its excise tax liability, Pan Am would have to keep track of flights by employees, retirees, and their dependents, who number in the aggregate approximately 100,000, and maintain the necessary verification for years. Moreover, correct valuation of employees' special low-priority standby status is certain to present many difficult issues and may result in protracted audit disputes between Pan Am and the Internal Revenue Service, neither of which organizations should be asked to devote scarce resources to those matters.

The combination of adverse factors involved with the excise tax has compelled Pan Am reluctantly to discontinue standby travel benefits to World Services.

5. *Pan Am cannot afford to lose this benefit now.*—As a result of the worldwide recession, high fuel costs, airline deregulation, and other factors, Pan Am has suffered significant losses over the last several years. Pan Am cannot suffer further deterioration at this time in employee morale. The proposal would help Pan Am now, but would be capped at present levels and would automatically phase out over time through attrition.

6. *The proposal would not set a precedent.*—Pan Am's proposal would not set a precedent. Section 531(f) of the Act already contains a relief provision for employees of affiliates of a corporation operating retail department stores. Pan Am's proposal is essentially the same in structure as section 531(f). Importantly, however, Pan Am's proposal applies only to individuals who were employed on September 12, 1984. The retail store rule applies to all employees of an affiliate, including future employees, as long as employees of the affiliate were entitled to an employee discount on October 5, 1983. Thus, the retail store rule will continue in force indefinitely. Pan Am's proposal, in contrast, is self-limiting and will phase itself out automatically through attrition of the group of covered employees.

CONCLUSION

Transitional relief is clearly required for individuals who have made career and personal decisions, often irreversible, in reliance on the continued availability of nontaxable standby air travel as an employee benefit. The proposal will provide relief only to those individuals. Persons employed after September 12, 1984, will not be covered.

Pan Am cannot solve the problem by electing to be subject to the excise tax. Because the bulk of Pan Am's employees are receiving nontaxable standby air travel in any event, the additional cost of the election would far exceed the value of any additional benefits provided to employees. Moreover, recordkeeping requirements would impose an unconscionable burden on Pan Am.

Pan Am has a strong need for transitional relief. Pan Am cannot afford to lose this benefit at this time. The relief requested would, however, automatically phase out over time.

Pan Am's proposal does not set a precedent. The Act already includes a similar grandfather rule for employees of retail store affiliates. Moreover, Pan Am's rule is much narrower in scope than the retail store rule because Pan Am's proposal would cover only persons employed on September 12, 1984, and not future employees.

Mr. BARNES. I would now like to introduce Mr. O'Brien and Harry James, who will offer brief comments.

Mr. GUARINI. Mr. O'Brien.

Mr. O'BRIEN. Thank you, Mr. Chairman, for the opportunity to give my testimony.

My name is James E. O'Brien. I currently reside in Florida. I am now retired, and worked for Pan Am World Airways for 35 years.

The first 12 years, beginning in late 1926, I operated a ground control approach radar for the airline in Gander, Newfoundland. Then, in early 1959, I was transferred to Pan Am's guided missiles range division at Cape Canaveral as an aircraft controller.

Subsequently, I was promoted to test operations controller. In this job, I was responsible for calling up all range resources in support of missile tests, including the manned Mercury and Gemini programs.

In 1979, I was detailed to Pan Am World Services and, in May 1981, I retired at age 66.

This law was passed 3 years after I retired. I had no way to know when I accepted my World Services' assignment, after so many years with Pan Am, that my family and I would be affected so adversely.

Reduced fare standby travel privileges were an important consideration of my staying with Pan Am over the years. We traveled extensively because of family medical problems while I was still working. Since I have retired, my wife and I travel to visit our children.

My plans for the future included such trips. However, without standby travel benefits, our finances now make this quite impossible.

Further, we certainly would not have planned our retirement home so distant from our children. I had no idea that this important benefit for which I had been eligible would suddenly become taxable and be taken from me.

In fairness, I ask you to make it possible for my family and I to receive my retirement benefits.

Mr. GUARINI. Thank you.

Mr. Harry James.

Mr. JAMES. Mr. Chairman, I would like to thank you for affording me the opportunity to testify today.

My name is Harry James. I am 57 years of age. For the past 27 years, I have worked for Pan Am World Airways.

Since 1979, I have been detailed to Pan Am World Services on a contract to operate and maintain downrange tracking stations on the U.S. Air Force test range. This range extended from Cape Canaveral to the remote island of Ascension in the south Atlantic Ocean. I am presently the base manager at the tracking station on Antigua.

I am proud to have participated in a program that was of national interest and which would open a new era for the airline industry of tomorrow with flights into space and other benefits.

During all these years of hardship on remote islands and separation from my family due to unavailability of adequate housing and limited schools for my three children, I relied upon the two or

three times a year when I could return home to my wife, parents, and children, utilizing my standby travel benefit privileges.

In addition, like many other fellow employees, I was relying on my standby travel benefits after retirement for my wife and I.

The Deficit Reduction Act resulted in the elimination of standby travel benefits for myself and employees like me, and created unforeseen problems to all those who made career decisions and sacrificed for many, many years.

I do believe that the effect that the Deficit Reduction Act created was unintentional.

Therefore, I plead with you, for fairness sake, to approve the proposed amendment that would provide relief and return these benefits, at least to those employees who were on the company's payroll on or before September 12, 1984.

Mr. GUARINI. Thank you.

Mr. Metze.

STATEMENT OF JARRED METZE, VICE PRESIDENT OF PERSONNEL, FLAGSHIP INTERNATIONAL, INC. (SKY CHEFS)

Mr. METZE. Yes, sir; I am Jarred Metze, vice president of personnel for Sky Chefs, accompanied by a number of Sky Chefs employees and Gene Overback, senior vice president, legislative affairs, with American Airlines. I appreciate the opportunity to testify here today as the representative of Flagship International, Inc., which does business under the name of Sky Chefs.

Sky Chefs is a wholly owned subsidiary of AMR Corp., a publicly owned holding company that also owns American Airlines, Inc. Sky Chefs furnishes food and beverages to air travelers. It operates flight kitchens, restaurants, and gift shops at airports throughout the United States.

I requested permission to appear here in order to explain the need for clarification with respect to the line of business restriction in section 132. The clarification is needed in the case of Sky Chefs, which is a separately incorporated arm of an overall airline service business. Our proposal would make it clear that in the case of a controlled group of corporations whose primary business was the provision of airline services, if one member of the group was involved in the provision of services for air passengers or for the operation of aircraft, that member would be treated as engaged in the same line of business as the group member offering air transportation to the public. This treatment would only apply, however, in cases where employees of the first member were eligible for no additional cost air transportation services as of October 5, 1983.

AIRLINE OPERATIONS IN GENERAL

The evolution of the airline industry illustrates how much more extensive the business of providing airline services is than simply operating aircraft. The provision of food and beverages to air travelers has evolved considerably since air travel first commenced. At the outset there was no food or beverages at airports where they operated. Eventually, airlines began to furnish food and beverages in flight.

Today domestic and foreign air carriers typically provide passengers with food and beverages while in flight, and a few also operate airport restaurants and gift shops. Many of the carriers serve food prepared by their own employees, although buying food from others at locations where they do not have their own flight kitchens. Some of these also cater meals for other carriers. Other airlines plan their own meals but, instead of preparing the meals themselves, obtain catering from other carriers or from noncarrier caterers.

SKY CHEFS' RELATIONSHIP TO AMERICAN

Sky Chefs essentially operates as the airline food arm of American. Although separately incorporated, the two companies share many administrative support functions, have common employee benefits plans, process employee transfers without loss of seniority or other benefits, and are both covered by the Railway Labor Act, which covers only transportation service industries, such as airlines and railroads.

Almost all of Sky Chefs' revenues are derived from planning and providing food and beverages for the convenience of air travelers through catering the meals that passengers of American and other airliines consume while onboard and operating airport restaurants for the convenience of airline passengers.

Employees of Sky Chefs have received, for over 40 years, as a benefit of employment, the privilege of traveling on a tax-free standby basis. This benefit continued after retirement.

NEED FOR CLARIFICATION

Because of the lack of definitive assurance as to how the line of business requirement of section 132 would be interpreted, the management of Sky Chefs has felt that it was unable to continue these travel benefits without risking potential liability for failure to withhold from the salaries of Sky Chefs' employees.

The change in Sky Chefs' longstanding travel privileges has already been the subject of a labor arbitration. The union withdrew its arbitration request in light of the company's agreement to endeavor to secure the restoration of the tax-free travel privileges while providing employees with an interim program of flight benefits at an increased charge, along with instituting a system of withholding with respect to such benefits. However, the arbitration may be resumed if the traditional benefit is not eventually restored. Moreover, Sky Chefs is experiencing difficulties in operating its business because of actual and threatened resignations of employees as well as an acute morale problem created by withdrawal of the traditional privilege. Finally, retired employees who enjoyed the tax free benefits while working for the company and who relied on the expectation of continued tax-free, low-cost flights are now facing severe financial hardship, as attested by numerous letters received by the company from them.

In order to secure the restoration of the tax free benefit, several months ago Sky Chefs, with the support of American, submitted to the Internal Revenue Sevice a request for a ruling that Sky Chefs is in the same line of business as American. The outlook for obtain-

ing the ruling is, however, bleak. Representatives from the Internal Revenue Service have told us that there would probably be no rulings issued in the fringe benefit area because of the virtual certainty of legislative and regulatory changes. Thus this avenue of obtaining the desired clarification seems to be closed. In light of this, Sky Chefs believes that there is a pressing need for legislative clarification that the line of business restriction on receipt of tax-free fringe benefits was not intended by Congress to deny individuals such as Sky Chefs employees tax-free treatment of the standby air travel privilege simply because many pieces of an airline's operation can be, and often are, operated as separate businesses.

REQUESTED CLARIFICATION

Sky Chefs is proposing that an amendment to an noncodified section of the Tax Reform Act of 1984 be incorporated into H.R. 1800. This seems to be the simplest way of achieving the necessary clarification. The text of the proposed amendment is attached to our prepared statement as exhibit I. The amendment would make it clear that all employees of an airline, whatever their individual responsibilities, should be able to continue to enjoy the privilege of free standby travel and that the separate incorporation of a piece of the airline's operations does not change this result.

The amendment would remove the cloud of uncertainty that has plagued the continued provision of tax-free air travel privileges within the airline industry. The clarification would also assure that employees of Sky Chefs are treated no differently than employees of the not separately incorporated food and beverage operations of several of American's competitors.

Thank you.

[An attachment to the prepared statement follows:]

AMENDMENT INSERTING NEW SUBSECTION (d) IN SECTION 153 OF H.R. 1800, THE TECHNICAL CORRECTIONS ACT OF 1985 [1]

(d) AMENDMENT TO SECTION 531 OF THE ACT.—Subsection (f) of section 531 of the Tax Reform Act of 1984 is amended to read as follows:

"(f) DETERMINATION OF LINE OF BUSINESS IN CASE OF AFFILIATED GROUP OPERATING RETAIL DEPARTMENT STORES *OR PROVIDING AIRLINE SERVICES*.—If—

"(1) as of October 5, 1983, the employees of one member of an affiliated group (as defined in section 1504 of the Internal Revenue Code of 1954 without regard to subsections (b)(2) and (b)(4) thereof) were

"(A) entitled to employee discounts at the retail department stores operated by another member of such affiliated group *or*

"(B) were eligible for no-additional-cost services in the form of air transportation provided by another member of such affiliated group, and

"(2) in the case of the member having employees described in paragraph (1)(B), such member is involved in the provision of services for air passengers or for the operation of aircraft, and

"(3) the primary business of the affiliated group is the operation of retail department stores *or the provision of airline services, as the case may be,*

then, for *the* purpose of applying section 132(a)(2) of the Internal Revenue Code of 1954, with respect to discounts provided for such employees at the retail department stores operated by such other member , *and for the purpose of applying sections 132(a)(1) and 132(a)(2) of the Internal Revenue Code of 1954, with respect to air transportation provided for such employees by such other member,* the employer shall be treated as engaged in the same line of business as such other member.".

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[1] Italic to show changes in existing section 531(f).

Mr. GUARINI. Thank you.
Mr. McGrath of New York.
Mr. MCGRATH. Thank you.

I would like to associate myself with the comments of Mr. Barnes and Mr. Metze as well as Mr. O'Brien and Mr. James. I believe that the effect of the line of business definition in the Deficit Reduction Act has had an unintended effect which adversely complicates the lives of employees and retirees of American Sky Chefs and Pan American Airlines and its affiliate World Services. I think that this perhaps would be a judicious point in our deliberation of a technical corrections bill to address this problem and this unintended, I believe, effect.

Thank you.
Mr. GUARINI. Thank you very much.
Mr. Pickle.
Mr. PICKLE. No questions.

Mr. GUARINI. I might say, Mr. Stark, I understand, has introduced a bill alleviating the difficulties that have arisen to Pan American employees and I am also cosponsor of the bill so you have a great deal of sympathy here to try to correct the problem that has arisen. However, I might say that if you had brought this to our attention when other people had brought their problems to us when we marked up the fringe benefit provisions in the bill that was passed, it wouldn't have necessitated your having to go to the trouble you have with IRS, having special legislation, having to come here today.

So all I can do is just say to be alert as to what your legal rights are. Your legal department could have saved a great amount of grief. In the long run, hopefully we can correct it. To be vigilent up front would have saved an awful lot of time for an awful lot of people.

Just let me ask Mr. Katz, you spoke of preexisting prenuptial agreements. Is that the problem you are addressing yourself to, the preexisting——

Mr. KATZ. Not prenuptial agreements, only participant designations prior to the effective date, for participants who died during this transitional period from August 23 to the first day of, say, 1985.

Mr. GUARINI. It is a narrow group you are addressing?

Mr. KATZ. That is who the transitional rule addresses, who the Technical Corrections Act addresses. There is a substantial number of people. There are cases all over the country that are being filed. It is a very substantial issue and has caused needless litigation because of participants who died thinking that their designated beneficiaries were going to get the benefits. They never knew about a change, and the plan was never changed. They never had an opportunity to consider the change. As a result, the children, or whoever happen to be designated beneficiaries, are filing suits saying "Constitutionally you are taking away my property without due process. I had a vested right to benefit under section 203(c), the plan says I get it. How can Congress say I don't have it?" As a result, we are having litigation all over the place. It is just unnecessary.

Historically, Congress has always given employers the chance to consider changes before they go into effect. This change went into

effect the day it was passed. The IRS always gives plans a chance to amend retroactively, usually during the year after a law is passed, to make a plan change. This is one of the few areas where a retroactive effect is being required.

One of the primary examples I guess was when ERISA first went into effect, unfunded liability on the termination of defined benefit plans was made retroactive. But this retroactive change affects the participants and beneficiaries, not just the employers, as was the case in the unfunded liability question.

So, I just don't think it is necessary to create all this litigation and take away rights of deceased participants for even a short period of time. I think the change should be effective in 1985 or 1986.

Mr. GUARINI. Is this potential litigation or litigation that is before the U.S. District Courts?

Mr. KATZ. There is litigation pending.

Mr. GUARINI. Presently pending?

Mr. KATZ. Yes, sir.

Mr. GUARINI. Thank you.

Gentlemen, I want to thank all of you for being here and giving your testimony. We will certainly take into consideration the comments and remarks you have made.

Thank you very much.

Mr. PICKLE [presiding]. The Chair would like to have the next panel come forward. That would be Ira Shapiro, Coopers & Lybrand; Edward Howard, Villers Foundation; ad hoc group of suppliers and users of railroad piggyback equipment, Dennis J. Kenny, accompanied by Dale W. Wickham, and Edward D. Heffernan. Will Mr. Shapiro, Edward Howard, Dennis Kenny and Mr. Edwards and the other representatives of the American Bar Association come forward if any are here. I see one gentleman here, Mr. Shapiro.

STATEMENT OF IRA H. SHAPIRO, DIRECTOR OF TAX POLICY, COOPERS & LYBRAND

Mr. SHAPIRO. Mr. Chairman, and members of the Committee on Ways and Means, I am pleased to be here today to offer our comments on H.R. 1800, the Technical Corrections Act of 1985. I am Ira Shapiro, director of tax policy for Coopers & Lybrand, an international accounting firm. I am appearing today on behalf of my firm.

My written statement addresses only the more important technical matters which have come to our attention in the 1984 Tax Reform Act, not already covered in H.R. 1800. We also have included one matter that has recently come to our attention which stems from the Tax Equity and Fiscal Responsibility Act of 1982. This issue from TEFRA is a matter which we believe the committee should give expeditious consideration in the context of this bill. With your permission, I will speak about it first.

In the 1982 tax bill, the items of tax preference for minimum tax purposes were expanded to include research and experimental expenditures under code section 174. This preference is among those that do not apply to corporations other than personal holding companies. What was not well understood at the time of TEFRA is that

the definitional aspects of the personal holding company rules are applying with increasing frequency to high technology companies that are in the startup and developmental stages of business. These companies—which often have narrow ownership and operate without significant operating revenues during their first few years—can be technically classified as personal holding companies despite the fact that they are active businesses. It is quite typical of a company such as this to operate at a net loss during the first 1 or 2 years, with its only earnings being interest on invested capital.

Although a company in this situation would not be subject to the personal holding company tax, nevertheless, as a consequence of coming within the definition of a personal holding company, the corporate add-on minimum tax of 15 percent would be imposed on its research and development expenditures. The actual payment of the minimum tax liability is deferred until the company becomes profitable.

Because of this deferred payment feature and the indirect application of the minimum tax to these companies, the nature of this problem has just begun to surface this tax filing season. It is not widely understood even at this time.

We do not believe that Congress intended to subject active, high technology companies to the minimum tax on their research and development expenditures. It should also be noted that there are important competitive concerns at stake since the issue is relevant only to startups, and not to established companies. We recommend that this problem be corrected retroactively in order to alleviate any liabilities that may have accrued for 1983 and 1984.

Proposed legislation by Congressman Stark would achieve this result by providing that R&D expenses under code section 174 are not to be considered a tax preference item for any corporation, including personal holding companies. We hope the committee will see fit to support this legislation and to include this correction in H.R. 1800 to ensure a timely resolution of this matter.

As to the 1984 act provisions, act section 147 which imposes an April 15 due date on all IRA contributions which can work an inordinate hardship on U.S. citizens residing abroad. Under current regulations, these taxpayers are granted an automatic 2 month extension to file their tax returns. We recommend that the same treatment be permitted for their IRA contributions. Other U.S. taxpayers are not subjected to the same uncertainty about the amount of their earned income for tax purposes. This uncertainty results from the adjustments available to U.S. citizens abroad under code section 911 as well as from the usual delay in receiving their W-2's, as late as February 28.

We have also raised an issue that arises in the context of the FSC provisions where a company having an FSC merges or acquires another company that has an interest charge DISC. A literal application of the statute appears to result in a disallowance of the FSC tax benefits to the company for the entire year. It is not clear that this effect was intended since the penalty seems disproportionate to the event. We raise this matter for your further consideration.

As our final point, we believe new code 761(e) which provides that any distribution of partnership interests will be treated as a

sale or exchange should be clarified to provide an exception for the distribution of a partnership interest to an estate or heir caused by the death of a partner. Otherwise, the death of a partner owning 50 percent or more of a partnership could cause a termination of the partnership with several adverse tax effects for the remaining partners, for example, investment tax credit recapture. Clearly death is not a tax planning tool for most partnerships and it does not seem appropriate to impose this sort of penalty on the remaining partners.

Thank you for your attention and I appreciate the opportunity to make this presentation today.

[The prepared statement follows:]

STATEMENT IRA H. SHAPIRO, DIRECTOR OF TAX POLICY, COOPERS & LYBRAND

Mr. Chairman and Members of the Committee on Ways and Means, I am pleased to be here today to offer our comments on H.R. 1800, the Technical Corrections Act of 1985, as part of the ongoing process of resolving questions and problem areas in the Tax Reform Act (TRA) of 1984. I am Ira Shapiro, Director of Tax Policy for Coopers & Lybrand, an international accounting firm with 90 offices in the U.S. alone. I am appearing today on behalf of my firm.

My statement addresses only the more important matters that have come to our attention in the 1984 legislation. We may provide additional comments for the record at a later date on some of the narrower technical issues of which we are aware. In addition, our statement includes a discussion of an issue from the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982 which has recently come to our attention. We believe it is a matter that deserves the Committee's expeditious consideration in the context of this bill.

What follows is a brief description of each of the issues we believe should be addressed in this year's technical corrections legislation, organized by the 1984 Act section. The first item is the matter from the 1982 Act which we believe should also be included in the bill.

TEFRA OF 1982, ACT § 201(b), ITEMS OF TAX PREFERENCE

In TEFRA, the items of tax preference were expanded to include research and experimental (R&E) expenditures under § 174. The preference amount is defined as the difference between the amount deducted under § 174(a) and the amount if amortized ratably over a 10-year period. However, this preference is among those that do not apply to corporations other than personal holding companies. What was not well understood at the time of TEFRA is that the definitional aspects of the personal holding company (PHC) rules under Code §§ 542 and 543 are applying with increasing frequency to high-technology companies in the start-up and developmental stages of their business.

These companies often have narrow ownership and operate without significant revenues during their first few years. Because of earnings on invested capital prior to its use in the business, a company with little other income can technically fall under the PHC rules during the start-up period. Ironically, the company would not be subject to the PHC tax in these early years since it has no taxable income, and it would not be a PHC in the later years when it has substantial operating income. However, its classification as a PHC for the loss years causes a minimum tax problem. Under the TEFRA change, 90% of the R&E expenses will now be subject to the add-on minimum tax of 15%, although payment is deferred until the company becomes profitable.

Because of this deferred payment feature and the indirect application of the tax to high-technology companies, the nature of the problem has just begun to surface during this tax filing season. We do not believe that Congress intended to subject these sorts of active companies to a minimum tax on their R&E expenditures. Such a tax amounts to a penalty on start-up companies not borne by more established firms. We recommend that this problem be corrected retroactively in order to alleviate any deferred tax liabilities that may have accrued in 1983 and 1984. Proposed legislation by Congressman Pete Stark would achieve this result by providing that R&E expenses under § 174 are not to be considered a tax preference item for any corporation, including personal holding companies. We hope the Committee will see

fit to expand the bill to include this correction to TEFRA in order that it can be enacted expeditiously.

1984 TRA § 75(b), DISTRIBUTIONS OF PARTNERSHIP INTERESTS TREATED AS EXCHANGES

Section 75(b) of the 1984 Act added a new Code § 761(e) which provides that a distribution shall be treated as a sale or exchange for purposes of §§ 708 (relating to continuation of a partnership), 743 (relating to the optional adjustment to the basis of partnership property), and any other provision of Subchapter K of the Code that is prescribed by the Secretary.

The proposed Technical Corrections Act clarifies that § 761(e) only applies to distributions of partnership interest. We believe that § 761(e) should be further clarified to indicate that any distribution of a partnership interest to an estate or heir caused by the death of a partner should not be treated as a "sale or exchange" for purposes of § 761(e).

Under the literal language of § 761(e), the death of a partner owning 50% or more of a partnership could cause a termination of the partnership with several adverse tax effects to the remaining partners (e.g., investment tax credit recapture). Clearly, death is not a tax planning tool in most partnerships, and a penalty should not be imposed on the remaining partners because of the death of a partner.

1984 TRA § 79, ALLOCATION OF CERTAIN LIABILITIES TO LIMITED PARTNERS

Act § 79 overturns the holding of the *Raphan* case. The legislative history on the intended effective date for this change is quite confused. The House Committee report cites an effective date rule of "amounts paid or incurred after March 1, 1984," while the conference report implies that transactions prior to March 1, 1984 would not be affected by the legislative change. The Joint Committee on Taxation General Explanation does not clarify the congressional intent but adds more confusion by including a parenthetical reference to losses accrued on or after March 1, 1984.

Even though *Raphan* has been subsequently reversed on appeal, the decision of the appellate court seems to indicate that the legal premise expressed by the lower court—that a partner can deal with the partnership "other than in his capacity as a partner"—was accepted. Therefore, it remains important for the Committee to clarify the intended effective date of the provision.

Since *Raphan* deals with the borrowing of money by a partnership which is guaranteed by the general partner, we believe the effective date should be clarified to apply to loans incurred or guaranteed after March 1, 1984.

1984 TRA § 147, DUE DATE OF INDIVIDUAL RETIREMENT ACCOUNT CONTRIBUTIONS

In Act § 147, the due date of April 15 was statutorily imposed for all IRA contributions without regard to extensions for the filing of individual tax returns (Code § 219(f)(3)(A)). In making this change, it does not appear that any consideration was given to the plight of U.S. citizens residing abroad. Under current regulations, these taxpayers are granted an automatic two-month extension to file their tax returns, until June 15 (Reg. § 1.6081-2(a)(5)). This rule recognizes the geographic and communication difficulties involved and the fact that most of these citizens do not even receive their W-2's until February 28 (Reg. § 31.6051-1(d)(2)).

We believe that U.S. citizens residing abroad should be allowed to make IRA contributions until the extended due date of their returns, June 15. We have raised this issue with the Department of Treasury and with congressional staff; a copy of our most recent correspondence on this issue is attached. In brief, we believe these taxpayers are at a disadvantage compared to U.S. residents in that they receive their W-2's late and will often not even know what their earned income is for tax purposes until the W-2 is received and the adjustments under Code § 911 are subsequently calculated.

It is small solace that, if these taxpayers inadvertently make excess contributions to their IRAs, they can withdraw the excess without penalty up until the return due date. This solution is one that forces this group of taxpayers to accept lower yields on their IRA savings by foreclosing longer term investments. It also subjects them to some inevitable degree of aggravation as they attempt to withdraw or reallocate any excess amounts. We hope the members of this Committee will reconsider the requirement of an April 15th deadline for this group of taxpayers, in light of the hardship it could impose and the slight effect it would have on the original purpose for the rule.

Title VIII of the 1984 Act establishes new rules to govern the formation and operation of Foreign Sales Corporations (FSCs) to replace Domestic International Sales Corporations (DISCs) and includes a number of provisions to govern the phase-out of existing DISCs, the utilization of interest charge DISCs, and other transition issues. As a result of the interaction of a number of these rules, it has come to our attention that potential problems can arise when a company with a FSC acquires or merges with another company that has an interest charge DISC. A literal application of the statutory rules would result in a failure to meet the FSC definition because of the prohibition against having an interest charge DISC and a FSC in the same corporate group "at any time during the taxable year" (Code § 922(a)(1)(F)).

The consequence of failure to meet the FSC definition appears to be a loss of the FSC tax benefits for the entire year. In addition, it appears that the interest charge DISC would be terminated as well. It is not at all clear that the Congress anticipated the problem outlined above or intended the results that appear to follow as a result of a merger involving a FSC and an interest charge DISC. The penalties certainly seem disproportionate to the event, and we believe the Committee's further consideration is warranted. One potential solution would be to allow some period of time in these circumstances for the target company to revoke its interest charge DISC election.

In a similar situation, where a company having a large FSC merges with another having a small FSC, the statute now appears to result in the loss of the tax benefits from the small FSC for the entire taxable year (Code § 922(b)(2)). Again, we call this matter to your attention in the event the result was unintended and warrants further consideration as to alternative solutions.

This concludes my testimony, and I would be happy to answer any questions the Committee might have.

COOPERS & LYBRAND,
Detroit, MI, March 27, 1985.

Re Suggested regulations for section 147 of TRA of 1984: Due date of IRA contributions.

Mr. RONALD A. PEARLMAN,
Assistant Secretary for Tax Policy, U.S. Department of Treasury, Washington, DC.

Mr. FRED T. GOLDBERG, Jr.,
Chief Counsel, Internal Revenue Service, Washington, DC.

DEAR MESSRS. PEARLMAN AND GOLDBERG: On October 31, 1984, I submitted a letter on behalf of Coopers & Lybrand which discussed the effects of Section 147 of the 1984 Tax Reform Act on U.S. citizens residing abroad. Due to the unique circumstances facing this group of U.S. taxpayers, we requested that the regulations provide U.S. taxpayers living abroad until June 15 to make their IRA contributions, since June 15 is actually the due date for filing these returns under Reg. 1.6081-2(a)(5). In support of this interpretation, we cited a number of other instances where administrative considerations have lead to delayed filing dates for this group of taxpayers. Also, we described the interactions of different tax provisions which complicate these returns.

Recently, in making an inquiry about the status of the proposed regulations in this area, we learned that there is reluctance on the part of some to provide an extended IRA contribution date for U.S. citizens residing abroad. Evidently, there are those who argue that unless the April 15 date is applied to all taxpayers, the administrative and enforcement posture of the IRS will not be significantly improved. Others seem to feel that taxpayers in the U.S. may have similar difficulties and thus relief should not be accorded any group of taxpayers. Further, it is argued that the ability of taxpayers to withdraw any excess contribution before the extended due date of the return, without penalty, adequately addresses the problems faced by this group.

To briefly respond without reiterating all the arguments made in our October 31, 1984 letter, U.S. citizens residing abroad do face unique and difficult circumstances which warrant separate consideration. This fact has been recognized throughout the regulations in developing administrative procedures and filing dates for these taxpayers. Further, it is not easy to fathom a case where a taxpayer resident in the U.S. will not know what his or her earned income will be for the year by the following January 31st. In contrast, taxpayers abroad will not even receive W-2's until after February 28 and still must compute the adjustments under Section 911 to determine what their earned income was for tax and IRA purposes. Indeed, allowing these taxpayers some additional time is not providing them special treatment but,

rather, is addressing the disadvantage these taxpayers have in comparison with U.S. based taxpayers.

Secondly, the argument that IRS administrative and enforcement procedures will be hampered if any group of taxpayers is allowed a later contribution date seems an exaggerated concern. Returns of these taxpayers are readily identifiable and are all processed at one service center, providing an easy means of segregating these returns for separate compliance tests, if necessary. It would seem that any other problems presented could be addressed through changes to the 1099 filing requirements or processing techniques. It seems possible that the financial institutions involved might even agree to expedite these 1099 filings in order to avoid the paperwork and other problems involved when the taxpayers making contributions must often withdraw them later.

Finally, we would urge that the hassle factor for these taxpayers warrants some consideration. Obviously, these savers will not be able to invest in long term IRA accounts because if adjustments are necessary to the amounts contributed, a penalty for premature withdrawal will be imposed by the financial institution. Some affected taxpayers will make this mistake and in effect will pay a penalty. All will be forced to accept lower yields on their IRA savings. Further, the process of withdrawing or reallocating amounts that turn out to be excess contributions will cause many difficulties with the personnel of financial institutions. These personnel will not usually be aware of the statutory rules providing that these amounts should not be reported as premature withdrawals or excess contributions if adjustments are made before the extended due date.

In conclusion, we believe the goals of sound tax administration are better served by providing that U.S. citizens residing abroad may make IRA contributions until June 15, the due date of their returns under Reg. 1.6081. If you have any further questions, please call me at 313/446-7339, or Ira Shapiro or Pam Pecarich in our Washington office at 212/822-4235.

Very truly yours,

JOHN T. HEITMANN,
Director, Services to Executives Abroad.

Mr. PICKLE. Thank you, Mr. Shapiro. We appreciate your testimony. You certainly have gone to the point of it. Did you skip over any one section or do you——

Mr. SHAPIRO. I believe we covered all of them.

Mr. PICKLE. I don't know that I have any questions about your recommended proposal.

Mr. McGrath, do you?

Mr. MCGRATH. No, but I thank Mr. Shapiro for his statement.

Mr. PICKLE. We thank you. I understand you checked with the staff on these matters too.

Mr. SHAPIRO. Yes, we have.

Mr. PICKLE. We appreciate that.

Is Mr. Edward Howard here?

You are Mr. Edward Heffernan, counsel for the National Association of Criminal Defense Lawyers?

Mr. HEFFERNAN. That is correct.

Mr. PICKLE. Who are the other two gentlemen?

Mr. TREANOR. My name is Gerard Treanor, Mr. Chairman. I am here on behalf of the National Association of Criminal Defense Lawyers.

Mr. PICKLE. Mr. Treanor, and the other gentleman?

Mr. EDWARDS. Yes sir, I am E.E. Edwards, Beau Edwards from Nashville.

Mr. PICKLE. Which one of you gentlemen want to make the presentation, or do each one of you have something to say?

Mr. HEFFERNAN. Mr. Edwards will make a statement if he could briefly.

STATEMENT OF E.E. EDWARDS III, CHAIRPERSON, DEFENSE FUNCTION COMMITTEE, CRIMINAL JUSTICE SECTION, AMERICAN BAR ASSOCIATION, ACCOMPANIED BY GERARD F. TREANOR, JR., AND EDWARD D. HEFFERNAN, BOTH ON BEHALF OF THE NATIONAL ASSOCIATION OF CRIMINAL DEFENSE LAWYERS

Mr. EDWARDS. Thank you, Mr. Chairman.

I am here representing the American Bar Association indirectly. I also am representing a number of bar groups around the country who have expressed concern about the same provision by adopting resolutions to that effect, including, for example, the American Trial Lawyers Association, the National Association of Criminal Defense Lawyers, which Mr. Treanor represents, the Illinois Bar Association, New York City Bar Association, Dade County, Florida Bar Association and so on.

I would suggest, Mr. Chairman, that as bar groups around the country become acquainted with the impact of the provision of 6050(i) on the attorney-client relationship, the response will be virtually unanimous in concern from the bar about the implication this has for citizens who wish to seek legal representation.

I have a prepared written statement which I would like to submit for the record, if I might, Mr. Chairman.

Mr. PICKLE. That will be granted.

Mr. EDWARDS. Thank you, sir.

Basically, our position is to urge Congress to exempt the attorney-client relationship from the currency reporting requirements of 6050(i) by an appropriate provision in the H.R. 1800 Technical Corrections Act of 1985.

The background of this, Mr. Chairman, is that last year the Senate added a provision to the Deficit Reduction Act of 1984, a provision which has from my understanding, never been considered by Ways and Means and that provision was retained in conference, but there was never a thorough consideration of the impact of these currencies reporting requirements in more subtle areas than the ares that were targeted.

The legislative history of the provision, limited though it is, very clearly indicates that the target, the congressional purpose and intent was to get at the so-called underground economy, to get some handle on large consumer transactions in cash such as purchases of automobiles in cash, of vacation packages and travel agencies, gems, furs, art objects at auctions, other large consumer items, and we certainly have no problem whatsoever with that purpose and intent.

The problem that has arisen is that the impact of the reporting provision on the attorney-client relationship, a relationship which is private, guarded and guaranteed by the sixth amendment, right to counsel. If you could just consider for a moment the problem that results if a man walks into a lawyer's office and says to the lawyer, I think I have a legal problem, let me tell you about it. And the lawyers sits down and listens to the man's explanation, and let's assume at that point that only Mr. Jones, who has come in seeking legal advice, legal counsel, and the lawyer are aware of the problem. He explains it to the lawyer.

The lawyer says, Mr. Jones, I think you have a legal problem, a serious problem, and it is something that is likely to require a lot of time and effort to work out.

Mr. Jones says, I want to retain you to work this problem out if you can, if it can be done without a lot of publicity. Publicity would be devastating to me, to my career, to my family and so on, but whatever you can do to represent me, please do it. I would like to retain you to represent me and I would like to pay you in cash because I want this to be a matter handled between the two of us as long as it can be.

The lawyer says, Mr. Jones I will be happy to do that but first, I am going to need your full name, your social security number, your passport number, and I am going to have to report you to the Government for retaining me.

I suspect that the first thing Mr. Jones is going to do is stand up and walk out of that lawyer's office and decide that maybe he will do the best he can to deal with his legal problem as long as he can without a lawyer because——

Mr. PICKLE. Why would that man hesitate to give to the lawyer his name and his address and his Social Security number?

Mr. EDWARDS. Because the man walked into the lawyer's office wanting to receive private legal counsel, wanting a lawyer to represent him and protect his interests, without letting the world know about it, and there are a number of instances where citizens have that sort of expectation of confidentiality. In fact in most attorney-client relationships.

For example, I am representing a lady in a domestic relations situation. Before we filed against her husband for a divorce, I represented her for 2 years on a cash basis. Her husband didn't know about it. She was afraid her husband would kill her if he found out that she had hired a lawyer.

There are probate matters, tax matters, administrative law matters, criminal matters obviously—the list could go on forever—where citizens need and want legal counsel on a confidential basis.

Mr. PICKLE. Mr. Edwards, I have asked a question. The red light has flashed on, I don't mean to restrict you like that, you go ahead. I want to hear the rest of your story.

Mr. EDWARDS. Thank you, sir.

Well, I think the bottom line, Mr. Chairman, is that the bar is very concerned that a right, a privilege of confidentiality which has existed in this country as long as we have been a Nation, has been seriously impacted and undermined without a great deal of thought about the impact of 6050(i). Citizens have always been able to go to a lawyer when they felt that they were threatened or wronged by their Government, or perhaps accused by their Government, with the confidence what they said to their attorney would be treated confidentially, and privately and that the relationship between them and their lawyer would be a confidential relationship. We suggest that section 6050(i) undermines in a very fundamental way the confidential relationship that citizens have always enjoyed in this country between themselves and their lawyers.

Looking at it for a second from the lawyers point of view, a lawyer presented with those circumstances is going to have to decide whether to breach his or her sworn obligation to protect the

secrecy and confidentiality of his client or to run a risk of endangering the interest of his clients by complying with the reporting provisions and that, I suggest, is an intolerable dilemma to place on the bar in a free society.

There are some circumstances, many circumstances in fact, where the identity of a lawyer's client and the circumstances of the payment of the fee are protected by the attorney-client privilege, and in those instances, the application of 6050(i) and the attorney-client privilege would come into direct conflict.

In other circumstances, the sixth amendment right to counsel and the fifth amendment right against incrimination would also come into direct conflict with the application of 6050(i) in this area.

There are certainly some cases wehre the identity of client and the fact that a fee has been paid, and how much, is not covered by the privilege, but I suggest that every case, every reported case in our country's history dealing with the scope of the attorney-client privilege, arose in a situation where the Government's attention was already focused on a client. The client had already been subpoenaed or arrested or indicted or in some way the Government's attention was focused on that client.

As I said, in some circumstances the attorney-client privilege protected the client's identity and in others it did not. But now, under 6050(i) for the first time, a lawyer would have to stand up before the Government's attention was focused on his client and wave a red flag and say to the Government, look at my client, you might find something you are interested in. I suggest respectfully that that is a circumstance that is simply intolerable in a nation dedicated to the rule of law.

[The prepared statement follows:]

Statement of E.E. Edwards III, Chairperson, Defense Function Committee, Criminal Justice Section, American Bar Association

Mr. Chairman and Members of the Committee:

My name is E. E. Edwards, III. I am a trial attorney and partner in the law firm of Edwards, Turner and Thompson in Nashville, Tennessee. I appear before you today on behalf of the more than 315,000-member American Bar Association.

Currently, I serve as Chairperson of the ABA Criminal Justice Section's Defense Function Committee. The Criminal Justice Section is one of two Sections within the Association that have been asked by the ABA House of Delegates to implement the position that I will articulate in this statement.

The American Bar Association includes within its organization a diverse array of law practice disciplines. Some of the Sections representative of these disciplines include "Criminal Justice," "Corporation, Banking and Business Law," "Real Property, Probate and Trust," and "Taxation."

All segments of the justice system are also represented in the Association. It includes judges, prosecutors, defense attorneys, academics and others.

In February 1985, the American Bar Association adopted a policy expressing concern about the ramifications of recently enacted 26 U.S.C. §6050I. Other organizations have passed similar resolutions. These include, for example, the American Trial Lawyers Association, the Illinois Bar Association, and the Association of the Bar of the City of New York. Examples of these resolutions are attached as Exhibit "A."

I appear before you to detail the reasons that lead to this policy's passage. I will also explain why it is appropriate for this Committee to amend H.R. 1800, the Technical Corrections Bill relating to the Tax Reform Act of 1984, to address the concerns that prompted the ABA to adopt this policy. The amendment we suggest as a remedy to the unique

dilemma posed for both attorneys and their clients by §6050I would include an exemption from that section's reporting requirements for the attorney-client relationship.

BACKGROUND ON PRESENT LAW

Section 6050I of Title 26 of the United States Code was one of the tax reform measures included in the Deficit Reduction Act of 1984. The statute provides that any person who receives more than $10,000 in cash, including foreign currency, in the course of trade or business must file a return with the Internal Revenue Service stating:

(1) the name, address and tax identification number of the person from whom the cash was received;
(2) the amount of cash received;
(3) the date and nature of the transaction; and
(4) such other information as the Secretary of the Treasury may require.

The reporting requirement applies if the cash is received in one transaction or "two or more related transactions." Although implementing regulations have not been promulgated, the Internal Revenue Service form for reporting currency transactions has been issued. It states that a report must be filed by the 15th day after the date of the transaction.

The statute imposes a second reporting obligation. Every person who filed a currency transaction return of the kind described above must annually furnish to each person whose name is set forth in the return a written statement showing; (1) the name and address of the person submitting the return; and (2) the aggregate amount of cash received by that person. This statement must be furnished to the payor on or before January 31st of the year following the calendar year in which the currency reporting return was filed.

The statute exempts three categories of cash transactions from the reporting requirements: (1) cash received in a transaction reported under Title 31, if the Secretary of the Treasury concludes that this

would result in duplicate reporting; (2) cash received by financial institutions, as that term is defined in 31 U.S.C. §5312(a)(2); and (3) except to the extent provided for in regulations, transactions occurring entirely outside the United States.

PENALTY PROVISIONS

Civil penalty provisions of Title 26 are applicable to failing to file or furnish the currency transaction reporting return or the annual statement. Penalties under §6652(a)(1) apply to failure to file the §6050I return.

Section 6652(a)(1) provides that each failure to file a return is subject to a $50 penalty "unless it is shown that such failure is due to reasonable cause and not willful neglect." The total penalty imposed during any calendar year cannot exceed $50,000.

Penalties under §§6652(a)(3)(A) and 6678 (a) are applicable to both the Internal Revenue Service return that must be filed and the annual statement that must be provided to persons that are the subject of the return. Section 6652(a)(3)(A) provides that if the failure to file the return is "due to intentional disregard of the filing requirement," it is subject to a $100 penalty and the $50,000 annual limitation does not apply. Section 6678(a) provides that each failure to submit an annual statement to the payor is subject to a $50 penalty unless the failure is due to reasonable cause and not to willful neglect. Again, the total penalties assessed during any calendar year cannot exceed $50,000.

In addition to the civil penalty provisions, the IRS has announced that a willful failure to file the currency transaction reporting return or to disclose information required by the form may result in a misdemeanor criminal prosecution under 26 U.S.C. §7203. A copy of the IRS press release is attached as Exhibit "B."

LEGISLATIVE HISTORY

The tax reform bill introduced in the House of Representatives did not contain a currency transaction reporting requirement. It was first proposed in the "Omnibus Reconciliation Act of 1983" introduced as Senate Bill 2062.

An excerpt from the Senate Budget Committee report discussing the relevant portion of the bill is attached as Exhibit "C." It provides some language important to understanding the legislative intent in passing the reporting requirement.

The report expresses the Committee's concern that "approximately 80 percent of the revenue lost through noncompliance [with the tax laws] is attributable to the underreporting of income." It notes a 1981 IRS estimate that taxpayers filing returns failed to report $134 billion in income and that non-filers failed to report an additional $115 billion. This resulted in total lost tax revenues of $55 billion. Unreported income generated from illegal activities resulted in an additional $9 billion in lost tax revenue. The report then states the Committee's belief that "reporting on the spending of large amounts of cash will enable the Internal Revenue Service to identify taxpayers with large cash incomes."

These passages make it clear that the purpose of the currency reporting requirement, as envisioned by the Senate Budget Committee, was to raise tax revenues by identifying individuals who were not accurately reporting their incomes. It was not viewed primarily as a criminal law enforcement measure.

The report also makes it clear that the reporting requirement applies with respect to any receipt of cash in connection with a trade or business "whether or not the receipt constitutes income in the trade or business." Therefore, if a retainer fee in excess of $10,000 is

deposited to an attorney's trust account, it would still have to be reported, even though the fee will be earned over a period of time, as services are rendered. Likewise, any cash sums that are the property of an estate or a client that are deposited with an attorney would also have to be reported.

The Conference Committee appointed to resolve differences between the House and Senate bills decided to include the currency transaction reporting requirement in the final Act. An excerpt from the Conference Committee report is attached as Exhibit "D." It is significant because it does not raise any addition points indicating that monies exchanged in the attorney-client relationship were intended to be embraced by the reporting requirement.

IRS FORM 8300

The Internal Revenue Service has issued Form 8300 for reporting currency transactions. A copy of the form is ttached as Exhibit "E." The form is significant in several respects.

As noted previously, the statute requires recipients of cash to file a return identifying the person "from whom the cash was received." The "plain meaning" of this phrase indicates that if a third party physically delivered a cash fee on behalf of the client, the return would only have to identify the third party.

Form 8300 alters and greatly expands the "plain meaning" of this statutory phrase. Part I of the form requires that identifying information be provided about the individual or organization "for whom this transaction was completed." Part II of the form requires the same information for the "individual conducting the transaction...." The form states that Part II is to be completed "only if an agent conducts a transaction for the person in part I." Thus, the form clearly requires

disclosure of the actual client's identity even if he does not personally tender the cash fee.

The form requires that the recipient of the cash disclose the following information about the payor and the transaction: (1) full name; (2) address; (3) employee identification number; (4) passport number and country of issuance; (5) alien registration number and country of issuance; (6) amount of cash received; (7) amount of cash received in the form of $100 bills; (8) nature of the transaction by general category (e.g., "business services provided"); (9) description of the property or service involved in the transaction; (10) method of payment (U.S. currency, coin or foreign currency); and (11) the date of payment. The recipient must also disclose his own name, address and social security or employee identification number. The form must be signed under penalty of perjury.

The "General Instructions" accompanying the form contain a statement which provides some insight into IRS' view of the purpose of the currency reporting requirement:

> "The Paperwork Reduction Act of 1980 says we must tell you why we are collecting this information, how we will use it, and whether you are required to provide it to us. The requested information is useful in criminal tax and regulatory investigations. In addition to directing the Federal Government's attention to unusual or questionable transactions, the reporting requirement discourages the use of currency in illegal transactions."

This statement reveals that the IRS views the currency reporting requirement as a tool for investigating and deterring criminal conduct, rather than a mechanism for raising tax revenues.

The instructions also state that the form is to be filed by the 15th day after the date of the transaction, either with the Internal Revenue

Service Data Center in Detroit, Michigan or by hand delivery to any local IRS office.

If the aggregate amount of cash received in two or more installment payments exceeds $10,000, the 15 day period is measured from the date of the payment that causes the aggregate amount to exceed $10,000.

Finally, in defining what constitutes a transaction in cash, the form provides that the reporting requirement applies only to the physical receipt of cash. It states, "A transaction in cash does not include a receipt of funds by means of bank check, bank draft, wire transfer, or other written order that does not include the physical transfer of cash."

PROBLEMS POSED BY THE REPORTING REQUIREMENT

Government within our country, at all levels, has historically recognized that certain relationships should be zealously protected from unwarranted intrusion, public or private. Among these, the attorney-client relationship is universally recognized and honored.

The currency transaction reporting requirement poses a serious threat to the integrity of the attorney-client relationship, particularly in the criminal defense area. The requirement that defense attorneys inform the IRS when a client pays a cash fee in excess of $10,000 will have a destructive effect on the actual ability of clients to retain lawyers. It will also adversely affect the trust and confidence essential to a meaningful attorney-client relationship.

Furthermore, the attorney's submission of the form will generate evidence which could be used against the client in a prosecution for tax evasion, participation in a continuing criminal enterprise, and other federal criminal offenses. It is also likely that defense attorneys who submit the forms will find themselves designated as government witnesses and disqualified from further representation of their clients.

Undercover operations designed to trap lawyers into violations of the reporting requirements are also a very real possibility.

The attorney-client relationship is so central to the position of the citizen vis-a-vis the government in our country that it is guaranteed and protected by the Sixth Amendment. At the core of this relationship guaranteed by the Amendment is the attorney-client privilege. Citizens must have the freedom to obtain and pay for legal consultation privately, without fear that their lawyer will be required to report the formation of the relationship or any details concerning it to anyone, including the government.

The policy behind the attorney-client privilege is to promote "freedom of consultation of legal advisers by clients" absent any apprehension that disclosures concerning the consultation can be compelled. United States vs. Hodge and Zweig, 548 F.2d 1347, 1353 (9th Cir. 1977), citing 8 J.Wigmore, Evidence, §2291 at 545 (McNaughton Rev.Ed 1961). Accord In Re Grand Jury Investigation, 723 F.2d 447, 451 (6th Cir. 1983). As a practical matter, if a citizen knows that information could "more readily be obtained from the attorney following disclosure than from himself in the absence of disclosure," the citizen will naturally become reluctant to seek out legal advice and to confide in his lawyer. Fisher v. United States, 425 U.S. 391, 403 (1976). It is virtually assured that §6050I's application will insidiously undermine the basic trust and reliance which citizens must have when they seek legal counsel.

In many instances §6050I will also directly violate the attorney-client privilege. It is frequently stated that "absent unusual circumstances the identity of the client does not come within the attorney-client privilege," Gannett v. First National State Bank of New Jersey, 546 F.2d 1072, 1073 n.4 (3rd Cir. 1976), cert. denied, 431 U.S.

954 (1977); In Re Grand Jury Procedures (Pavlick), 680 F.2d 1026 (5th Cir. 1982)(en banc), and that the legal fee paid by the client is also not within the privilege. See In Re Michaelson, 511 F.2d 882, 888 (9th Cir.), cert. denied, 421 U.S. 978 (1975); In Re Grand Jury Proceedings, 517 F.2d 666, 670 (5th Cir. 1975). So many circumstances have been identified as exceptions, however, the exceptions have become as prevalent as the general rule.

Courts have decided the applicability of the privilege based upon a case by case analysis. Never has there been any willingness to permit wholesale disclosure requirements, some of which would clearly invade constitutionally protected rights and relationships.

The client's identity is protected by the privilege when the client himself would be privileged from such a disclosure. See Fisher, supra 425 U.S. at 404. For example, when a client would have a fifth amendment privilege to refuse to answer questions about cash payments made by him, his attorney could not be compelled to disclose facts about the payment.

Where a strong possibility exists that disclosure of information would implicate the client in the very matter for which legal advice was sought, the privilege applies. In Re Grand Jury Subpoenas Duces Tecum (Marger/Merenbach), 695 F.2d 363, 365 (9th Cir. 1982); In Re Walch, 623 F.2d 489, 495 (7th Cir.), cert. denied, 449 U.S. 994 (1980); In Re Grand Jury Investigation (Tinari), 631 F.2d 17, 19 (3rd Cir. 1980), cert. denied, 449 U.S. 1083 (1981). The client's identity is also privileged where the disclosure would be tantamount to disclosing an otherwise protected confidential communication, Baird v. Koerner, 279 F.2d 623, 632 (9th Cir. 1960), and where so much of the actual communication has already been disclosed that identification of the client amounts to disclosure of a confidential communication. NLRB v. Harvey, 349 F.2d 900, 905 (4th Cir. 1965); United States v. Tratner, 511 F.2d 248, 252

(7th Cir. 1975); Colton v. United States, 306 F.2d 633, 637 (2nd Cir. 1962), cert. denied, 371 U.S. 951 (1963). Another exception is recognized when disclosure of the identity of the client would provide the "last link" of evidence in an existing chain of incriminating evidence likely to lead to the client's indictment. In Re Grand Jury Proceedings (Pavlick), supra; In Re Grand Jury Proceedings (Twist), 689 F.2d 1351, 1352-2 (11th Cir. 1982).

From a broader perspective, every reported case construing the attorney-client privilege arose because the government was focusing, in some manner, attention on some individual who happened to be the attorney's client. The individual had been subpoenaed, or arrested, or indicted, or in some manner had come to the attention of the government.

For the first time in our history, §6050I marks a basic departure from every reported case. For now, a lawyer will be placed in the position of "waiving the flag" at the government and calling the government's attention to a client, in whom, the government may have had no interest. This would be triggered simply by the client's seeking to obtain legal assistance and paying in cash.

Lawyers in many states will have an ethical duty to resist the application of §6050I to their clients under their duty to "preserve the confidences and secrets of a client" Canon 4. This Canon has been widely construed as establishing a duty for lawyers to protect more than only the privileged disclosures of their clients, but extending to any matter which "could be embarrassing or would likely be detrimental to the client." Disciplinary Rule 4-101(a); Standard 28(c); Ethical Consideration 4-1 and 4-5. See State Bar of Georgia, Advisory Opinion Number 41 (September 24, 1984); District of Columbia Bar Association, Committee on Legal Ethics Opinion, Committee on Legal Ethics Opinion Number 124 (March 22, 1983); Philadelphia Bar Association, Professional

Guidance Committee Opinion Number 81-95 (undated); Birmingham Bar Association, Opinion of Professional Ethics (unnumbered) (January 9, 1981); Connecticut Bar Association, Committee on Professional EThics Informal Opinion Number 81-3 (October 9, 1980). Several of these ethical opinions also suggest that an attorney has a duty to utilize all appellate avenues before making any compelled disclosure.

The target of §6050I was obviously the disclosure of large consumer transactions, not transactions relating to privileged relationships which, in economic terms constitute but a drop in the bucket. Because the attention of Congress was focused on other types of transactions, apparently no thought was given to the impact of §6050I on attorney-client relationships.

We urge that, by amending H.R. 1800, transactions which establish or maintain a privileged attorney-client relationship be exempted from the application of §6050I. Such an exemption would avoid a quagmire of litigation, including questions of constitutionality, and would detract little from the overall impact of this section's intended purpose -- revenue collection.

CONCLUSION

In summary, three points are important to reiterate:

1. It seems readily apparent that Congress, in passing §6050I, did not focus on its potential impact on the attorney-client relationship and did not intend to affect that relationship.
2. The purpose of the currency reporting requirement was to raise tax revenues not to create a new criminal law enforcement measure.
3. Section 6050I, however unintended, seriously erodes the confidentiality of attorney-client relationships. It threatens the ethical obligation of attorneys to protect their client's

secrets and confidences. In certain circumstances, it would violate the attorney-client privilege and would be unenforceable as an unconstitutional violation of the Fifth and Sixth Amendments. Furthermore, the revenue to be gained by eroding the attorney-client relationship is minimal.

Therefore, it is wholly appropriate for the Committee on Ways and Means to include a provision in H.R. 1800 exempting the attorney-client relationship from the requirements of §6050I of the Internal Revenue Code. This is a practical application of the technical corrections process to clear up a problem that Congress never intended to create by enacting the law.

Thank you very much for the opportunity to bring this to your attention.

Attachments

American Bar Association

EXHIBIT "A"

SECRETARY
William H. Neukom
3500 First Interstate Center
Seattle, WA 98104

WRITER'S DIRECT LINE 312/988-5155

March 18, 1985

Honorable Daniel Rostenkowski
Chairman, Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

RE: Deficit Reduction Act

Dear Mr. Chairman:

At the meeting of the House of Delegates of the American Bar Association held February 18-19, 1985, the attached resolution was adopted upon recommendation of the Illinois State Bar Association. The action taken thus becomes the official policy of the Association in this matter.

This resolution is transmitted for your information and whatever action you may deem appropriate. If hearings are scheduled on the subject of this resolution we would appreciate your advising Robert D. Evans, Director of the American Bar Association Governmental Affairs Group, 1800 M Street, N.W., Washington, D.C. 20036, (202/331-2214).

Please do not hesitate to let us know if you need any further information, have any questions or if we can be of any assistance.

Sincerely yours,

William H. Neukom

WHN:dmb
Attachment
1619f/0268q/0269q

cc: Jon W. DeMoss, Esquire
President, Illinois State Bar Association
Robert D. Evans, Esquire

750 NORTH LAKE SHORE DRIVE, CHICAGO, ILLINOIS 60611
TELEPHONE (312) 988-5000

Resolution Adopted
by the
American Bar Association
House of Delegates

1985 Midyear Meeting
February 18-19, 1985

Report No. 8C

BE IT RESOLVED, That the American Bar Association expresses deepest concern over the effect upon the attorney-client privilege and upon the confidentiality of the attorney-client relationship of Section 6050I of the Internal Revenue Code, added by Section 146 of Title I of the Deficit Reduction Act of 1984, which requires disclosure of certain cash receipts in excess of $10,000;

BE IT FURTHER RESOLVED, That the American Bar Association urges the Department of the Treasury to delay issuance of regulations implementing Section 6050I with respect to receipt by lawyers of cash fees or expenses for legal services until an appropriate solution to this problem can be devised; and

BE IT FURTHER RESOLVED, That the Sections of Taxation and of Criminal Justice be authorized and directed to work with Treasury Department and Internal Revenue Service officials and with appropriate Committees of the Congress in an effort to exempt from disclosure requirements cash fees or expenses received by lawyers for legal services.

THE ASSOCIATION OF TRIAL LAWYERS OF AMERICA
1050 31ST STREET, N.W., WASHINGTON, D.C. 20007-4499 (202) 965-3500

CRIMINAL LAW SECTION

Jack B. Zimmermann
Chairman

Five Post Oak Park
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(305) 684-9000

Joseph Lawless, Jr.
Secretary
Fourteenth Floor
Three Penn Center Plaza
Philadelphia, PA 19102
(215) 496-0755

May 1, 1985

Barry Tarlow, Esquire
9119 Sunset Boulevard
Los Angeles, California 90069

Dear Barry,

Enclosed is a copy of the Resolution passed by the Board Of Governors of the Association of Trial Lawyers of America at its meeting in Austin, Texas on April 26, 1985.

Please advise me as soon as possible as to who I should contact, or advise the appropriate person to contact me, so that the Association of Trial Lawyers of America can work in conjunction with the American Bar Association and National Association of Criminal Defense Lawyers on this matter. Our civil lawyers were as concerned about this as were the criminal defense lawyers.

ATLA's 50,000 members should be a positive influence in this fight.

Sincerely,

Jack

Jack B. Zimmermann

JBZ/wb

Enclosure

cc: National Officers & Executive Committee
Officers, Criminal Law Section
Ms. Marianna Smith
Mr. Alan Parker
Mr. Michael Starr
Mr. Sidney Bernstein
Mr. Mark Kadish

BE IT RESOLVED, that the Criminal Law Section of the Association of Trial Lawyers of America expresses deepest concern over the effect upon the attorney-client privilege and upon the confidentiality of the attorney-client relationship of Section 60501 of the Internal Revenue Code, added by Section 146 of Title 1 of the Deficit Reduction Act of 1984, which requires disclosure of certain cash receipts in excess of $10,000;

BE IF FURTHER RESOLVED, that the Association of Trial Lawyers of America urges the Department of the Treasury to delay issuance of regulations implementing Section 60501 with respect to receipt by lawyers of cash fees or expenses for legal services until an appropriate solution to this problem can be devised; and

BE IT FURTHER RESOLVED, that the Board of Governors of the Association of Trial Lawyers of America appoint the Chairman of the Criminal Law Section to head a committee to work with Treasury Department and Internal Revenue Service Officials and with appropriate Committees of the Congress in an effort to exempt from disclosure requirements cash fees or expenses received by lawyers for legal services.

Sidney Bernstein,
Former Chairman
Criminal Law Section

Kluwer Law Book Publishers, Inc.
The Bar Building
36 West 44 Street
New York, NY 10036

Jack B. Zimmermann
Chairman
Criminal Law Section

Law Offices Of Jack B. Zimmermann
Five Post Oak Park
Suite 1130
Houston, Texas 77027

EXHIBIT "B"

News Release

Department of the Treasury
Internal Revenue Service
Public Affairs Division
Washington, DC 20224

Media Contact: Tel. (202) 566-4024
Copies: Tel. (202) 566-4054

For Release: 12/20/84

IR-84-132

Washington -- The Internal Revenue Service today announced the availability of Form 8300, Report of Cash Payments Over $10,000 Received in a Trade or Business.

The Tax Reform Act of 1984 provides that any person who in trade or business receives more than $10,000 in cash, including foreign currency, after 1984 in one transaction or related transactions must file a return of this information to the IRS.

Banks and other financial institutions required under the Bank Secrecy Act to report cash transactions of more than $10,000 to the Treasury are not required to file Form 8300. Also, reporting is not required for transactions entirely outside the United States.

Form 8300 contains provisions for the payer's name, address and tax identification number, the amount received and the date and nature of the transaction. The law requires that a written statement must also be provided to the payer. A copy of Form 8300 may be used as the statement.

A person who fails to file required Forms 8300 with the IRS or to furnish the payer with the required statement is subject to a $50 penalty per failure, up to a $50,000 maximum penalty per calendar year. No penalty will be imposed if the failure is shown to be due to reasonable cause and not to willful neglect. If the failure to file Form 8300 is intentional, the

civil penalty increases to $100 per failure, without the $50,000 annual limitation. Any taxpayer who willfully fails to file Form 8300 may be subject to a criminal fine of not more than $25,000 -- $100,000 in the case of a corporation -- and imprisonment for up to one year.

Forms can be obtained from the appropriate IRS Forms Distribution Center.

EXHIBIT "C"

Calendar No. 537

98TH CONGRESS 1st Session	SENATE	REPORT No. 98-300

OMNIBUS RECONCILIATION ACT OF 1983

REPORT

OF THE

COMMITTEE ON THE BUDGET

UNITED STATES SENATE

TO ACCOMPANY

S. 2062

A BILL TO PROVIDE FOR RECONCILIATION PURSUANT TO SECTION 3 OF THE FIRST CONCURRENT RESOLUTION ON THE BUDGET FOR FISCAL YEAR 1984 (H. CON. RES. 91, NINETY-EIGHTH CONGRESS)

together with

ADDITIONAL VIEWS

NOVEMBER 4, 1983.—Ordered to be printed

U.S. GOVERNMENT PRINTING OFFICE

35-681 O WASHINGTON : 1983

allowability of any deduction or credit, the excludability of any income, or the securing of any other tax benefit by reason of holding an interest in the entity or participating in the plan or arrangement, must maintain customer lists. These lists must show the name, address, and taxpayer identification number of each person investing in each plan or arrangement which the person organizes or sells. In addition, the Secretary is given authority to require such other information as he finds necessary. These lists must enable the Secretary to identify every purchaser of a given type of investment scheme. To this end, the Secretary may require the promoter to maintain these lists by reference to specific identifying characteristics relating to their purported tax treatment. These requirements do not apply with respect to partnership interests or subchapter S share ownership because such arrangements are already subject to special audit rules under the Code. Information must be retained for seven years after it is first required to be listed.

If the Secretary determines that the list requirement of this new provision is inconsistent with, or redundant vis-a-vis, any other provision of the Code, he may provide appropriate exceptions to the list requirement. Similarly, he may provide rules to eliminate maintenance of duplicate lists under this provision.

Any promoter or salesman who is required to maintain lists under the new provisions of the bill will be subject to a penalty comparable to that imposed on income tax return preparers who fail to maintain required lists. Thus, each failure to retain a record of any particular purchaser of an investment, will be subject to a $50 penalty except when the failure results from reasonable cause and not from willful neglect. Unlike the return preparer penalty, however, the penalty for failure to maintain required promoter lists is not subject to an aggregate annual limitation.

Effective Date

This list requirement applies to investments sold after December 31, 1983.

2. Reporting with Respect to Cash Transactions and Mortgage Interest (sec. 122 of the bill and new sec. 6050H of the Code)

Present Law

Cash transactions.—In addition to the information reporting required by the Code, the Bank Secrecy Act authorizes the Secretary to require reporting of certain financial transactions. Under these rules, certain banks and other financial institutions are required to report cash transactions (including deposits and withdrawals) of more than $10,000. The Treasury regulations provide a number of exceptions to this reporting requirement. Also, persons who bring or send more than $5,000 in cash or other bearer instruments into or out of the United States must report the event to the United States Customs Service. Finally, a United States taxpayer who files a tax return is required to notify the Internal Revenue Service, where provided for on the tax return, of the existence of a foreign bank account or other foreign financial account that he controls or

in which he has an interest. If the amount in the account exceeds $1,000, then the amount must be reported on a separate form to the Treasury Department.

Bank Secrecy Act information is compiled by the Treasury Department, and made available to agents of the Internal Revenue Service.

Mortgage interest.—Under present law, interest paid on a mortgage is deductible in computing taxable income. There is, however, no requirement that the recipients of such interest provide information with respect to the payment to the Internal Revenue Service.

Reasons for Change

The committee is concerned that approximately 80 percent of the revenue lost through noncompliance is attributable to the underreporting of income. For 1981, the Internal Revenue Service estimates that taxpayers filing returns failed to report $134 billion of income and nonfilers failed to report $115 billion. This $250 billion of underreporting reduced tax receipts by an estimated $55 billion. Unreported income connected with illegal activities was estimated to result in an additional $9 billion of lost revenue. The committee believes that reporting on the spending of large amounts of cash will enable the Internal Revenue Service to identify taxpayers with large cash incomes.

In addition, the committee believes that a provision requiring recipients of mortgage interest payments in excess of $2,300 to report the interest received to the Internal Revenue Service (with a copy to the payor) will materially assist the Internal Revenue Service in verifying the accuracy of claimed mortgage interest deductions. Internal Revenue Service studies indicate that a significant percentage of all overstated deductions involves overstatement of interest deductions.

Explanation of Provision

Cash transactions.—Under the bill, any person who receives (for his own account or the account of another) cash in connection with a trade or business will be required to report on any transaction in which the amount of this cash received is $10,000 or more. A transaction subject to reporting is any receipt of cash including receipt in connection with the purchase of goods or services, the purchase or exchange of property, the opening of a deposit or credit account, the purchase of gambling chips, or any similar transaction. For this purpose, a series of related transactions will be treated as a single transaction.

This new reporting requirement is imposed with respect to any receipt of cash in connection with a trade or business whether or not the receipt constitutes income in the trade or business. Thus, reporting is required whether or not consideration is returned for the cash and whether or not the cash is received for the recipients' account or for the account of another. An exception is provided in the case of transactions subject to reporting under the Bank Secrecy Act.

The recipient of the cash will be required to report the name, address, and identifying number of the payor, the date and nature of the transaction and such other information as the Secretary may require. In addition to furnishing reports on each cash transaction to the Internal Revenue Service, the recipient of the cash must furnish each payor an annual statement aggregating the amounts of cash received from him. Such statement must be furnished on or before January 31 of the year following the year of the reportable event.

The bill defines cash for purposes of this provision as including only U.S. and foreign currency.

Mortgage interest.—Under the bill, any person who, in connection with a trade or business, receives $2,300 or more of mortgage interest payments from any person during the calendar year will be required to report the payor's, name, address, and taxpayer identification number and such other information as the Secretary may prescribe. This reporting requirement applies not only to the person entitled to the interest, but also to persons (such as service companies) who receive interest payments on behalf of another. For this purpose, mortgage interest is any interest on an obligation secured by an interest in real property (including, however, interest payable under a contract for deed) and amounts paid in lieu of interest for which a deduction is allowed. In addition to furnishing reports on mortgage interest receipts of $2300 or more for any calendar year to the Internal Revenue Service, the payment recipient must furnish to each payor an annual statement of the amount of mortgage interest received from that payor in the calendar year. Such statements are due on or before January 31 of the year following the calendar year for which the return is made.

The committee decided to require reporting only where the amount of interest exceeds $2,300 because payments in excess of that amount generally allow individual payors to claim itemized deductions.

Penalties.—The penalty for failure to make required reports will be similar to that imposed on failures to make other information reports. Thus, the penalty will be $50 per failure, subject to a maximum of $50,000 for any calendar year. The penalty is not applicable if the failure is due to reasonable cause and not to willful neglect. If, however, the failure to file is due to intentional disregard of the filing requirements, the penalty is not less than 10 percent of the aggregate amount not properly reported and the $50,000 limitation will not apply.

Effective Date

This new reporting requirement will apply to amounts received after December 31, 1983.

2. Tax Court Small Tax Case Provision (sec. 123 of the bill and sec. 7463 of the Code)

Present Law

Under present law, taxpayers using the "small tax case" procedure may appear pro se or be represented by any person admitted

EXHIBIT "D"

tary may, if he considers it appropriate, provide for an exception from reporting for interest paid on credit cards that are secured by real property. This exception would be appropriate if the Secretary determines that such interest is most likely to show on returns as interest on credit cards rather than home mortgage interest. The conferees do not intend that the Secretary except from reporting interest that is reported on Schedule A as home mortgage interest. The agreement also provides the Secretary with authority to issue regulations to eliminate duplicative reports.

The conferees anticipate that recipients of mortgage interest will require the payor to furnish his taxpayer identification number as part of the mortgage loan approval or closing process for mortgage loans entered into after December 31, 1984.

With respect to mortgage loans in existence on December 31, 1984, the conferees anticipate that the Secretary will require recipients of mortgage interest to request, at least once a year, from each payor the payor's taxpayer identification number, unless the recipient already has the payor's number in its accounting system. The conferees anticipate that the Secretary will permit these requests for a payor's taxpayer identification number to be included in the recipient's regular mailings of either payment coupon booklets or annual statements to the payor. Recipients will not be required to make separate mailings of these requests, unless the recipient does not otherwise contact the payor at least once each calendar year. The conferees anticipate that the first request will be made as soon as practicable, but in no event later than with the first mailing by the recipient to the payor in 1985. The conferees also anticipate that recipients will notify payors that the Internal Revenue Service requires the payor to furnish its taxpayer identification number in order to verify the payor's deduction for mortgage interest and that the payor is subject to a $50 penalty by the Internal Revenue Service if the payor fails to furnish its taxpayer identification number. If the interest recipient makes the annual requests described above, and properly and promptly processes the responses, it will not be subject to any penalty for failure to include a TIN on its information return to the Internal Revenue Service because the payor's failure to supply the requested number will constitute reasonable cause for failure to supply the number to the Internal Revenue Service.

The conferees intend that the Secretary coordinate the requirement that a statement be furnished to the payor under this provision with other requirements, such as those of Federal mortgage programs, that similar statements be furnished, so that duplicative reporting is minimized.

b. Returns relating to cash received in a trade or business

Present law

Under the Bank Secrecy Act, certain banks and other financial institutions are required to report cash transactions of more than $10,000.

House bill

No provision.

LEGISLATIVE HISTORY

P.L. 98-369

[page 983]

Senate amendment

A person engaged in a trade or business who receives, in the course of the trade or business, $10,000 or more in cash or foreign currency in one or more related transactions must report it to the Internal Revenue Service and provide a statement to the payor. Amounts required to be reported under the Bank Secrecy Act are excepted from this reporting requirement. Present law penalties for other failures to file information returns and statements apply (generally, $50 per failure except in cases of intentional disregard). The provision is effective for amounts received after December 31, 1984.

Conference agreement

The conference agreement generally follows the Senate amendment. Thus, reporting is required only for payments of more than $10,000 that are received by a person in the course of his trade or business. Reporting is not required on payments (a) that are received in a transaction reported under the Bank Secrecy Act if the Secretary determines that the report under this provision would duplicate the report under Bank Secrecy, or (b) that are received by certain specified financial institutions within the meaning of the Bank Secrecy Act.

With respect to these specified financial institutions, the conferees do not intend to affect the detailed reporting rules and exceptions which Treasury has developed. The other categories of financial institutions that are not specified as exempt from reporting under this provision have generally been exempted by Treasury from Bank Secrecy reporting. Examples of these other entities are certain dealers in precious metals, stones, or jewels, pawnbrokers, loan or finance companies, insurance companies, and travel agencies. These entities are required to report under this new provision. To the extent that Treasury also requires that they report transactions under Bank Secrecy, the Secretary can provide that duplicative reports that would be made on those transactions pursuant to this provision need not be made.

The conferees understand that the Treasury is considering extending certain Bank Secrecy Act reporting to casinos and other establishments. To avoid duplicative reporting requirements, the Secretary has discretion under the conference agreement and the Bank Secrecy Act to review the obligations imposed under the Bank Secrecy Act and to eliminate any reporting required under the conference agreement if the Bank Secrecy reporting, in substance, provides for the reporting of transactions required to be reported under the conference agreement with respect to the information that must be provided to the Treasury.

Under this provision, any taxpayer required to report under this provision who is in a trade or business and who, in the course of the trade or business, receives more than $10,000 in cash in one or more related transactions must report those transactions. For example, assume that an individual purchases a $8,000 item and a $1,500 item at an auction. The auction house adds a 10% buyer's premium and the local sales tax, at a 5% rate. The taxpayer pays his $10,972.50 bill in cash. The auction house must report on that

transaction. The auction house could not avoid the reporting requirement by presenting two separate bills of $9,240 and $1,732.50.

e. Provisions relating to individual retirement accounts

Present law

The trustee of an IRA is required to report to the IRS and to the owner of the IRA on contributions or withdrawals made. Each failure to provide a report on a contribution or withdrawal is subject to a $10 penalty. Contributions must be made by the due date (including extensions) of the return for the year to which the contributions relate.

House bill

The report must identify the years to which IRA contributions relate, effective for contributions made after April 15, 1984, relating to years beginning after December 31, 1983. The penalty is increased to $50 for each failure to provide a report on contributions or withdrawals, effective on the date of enactment.

Senate amendment

The report must identify the years to which IRA contributions relate effective for contributions made after 30 days after enactment for taxable years beginning after December 31, 1983. The penalty is increased to $50 for each failure to provide a report on contributions or withdrawals, effective on the date of enactment. Contributions must be made by the due date of the return (without extensions), effective for contributions made more than 30 days after the date of enactment, for taxable years beginning after December 31, 1983

Conference agreement

The conference agreement follows the Senate amendment, except that the provision is effective for contributions made after December 31, 1984. The conferees wish to clarify that the trustee may require that the owner of the IRA certify as to which year a contribution relates and that, except in unusual circumstances, the trustee may rely on that certification.

The date by which this report must be provided to the Internal Revenue Service and the periods to which the report relates are to be specified by the Secretary in regulations. The conferees intend that generally trustees will be required to report only once a year on the cumulative total of contributions relating to a particular taxable year. The Secretary may, however, provide for more frequent reporting if he determines that it is appropriate to do so. As to the date by which the report must be provided to the Internal Revenue Service, the Secretary could, for example, require reporting by the end of May on all IRA contributions relating to the taxable year with respect to which the individual's tax return was due on the preceding April 15.

EXHIBIT "E"

Form **8300** (Rev.)
(Rev. January 1988)
Department of the Treasury
Internal Revenue Service

Report of Cash Payments Over $10,000 Received in a Trade or Business

OMB No. 1545-0892
Expires: 12-31-88

Part I Individual or Organization for Whom This Transaction Was Completed

Individual's last name	First name	M.I.	Social security number

Name of organization	Employer identification number	Passport number	Country

Number and street	Business or occupation	Alien registration number	Country

City	State	ZIP code	Country (if not U.S.)	Other identifying data (Specify)

Part II Identity of Individual Conducting the Transaction (Complete only if an agent conducts a transaction for the person in Part I)

Last name	First name	M.I.	Social security number

Number and street	Passport number	Country	Alien registration number	Country

City	State	ZIP code	Country (if not U.S.)	Other identifying data (Specify)

Part III Description of Transaction and Method of Payment

1 Amount of cash received $

2 Amount in item 1 in $100 bills $

3 Nature of transaction

- a ☐ personal property purchased
- b ☐ real property purchased
- c ☐ personal services provided
- d ☐ business services provided
- e ☐ intangible property purchased
- f ☐ debt obligation paid
- g ☐ exchange of cash
- h ☐ escrow or trust funds
- i ☐ other (specify) ▶

Description of property or service

4 Method of payment by customer

- a ☐ paid with U.S. currency or coin
- b ☐ paid with foreign currency (describe)

5 Date paid

Part IV Business Reporting This Transaction

Name of reporting business	Identification number (EIN or SSN)

Street address	Nature of your business

City	State	ZIP code

Under penalties of perjury, I declare that the information I have furnished above, to the best of my knowledge, is true, correct, and complete.

SIGN HERE ▶

(Authorized Signature—See instructions) (Title) (Date)

For Paperwork Reduction Act Notice, see page 2.

Form 8300 (Rev. 1-88)

General Instructions

Paperwork Reduction Act Notice.—The Paperwork Reduction Act of 1980 says we must tell you why we are collecting this information, how we will use it, and whether you are required to provide it to us. The requested information is useful in criminal, tax, and regulatory investigations. In addition to directing the Federal Government's attention to unusual or questionable transactions, the reporting requirement discourages the use of currency in illegal transactions. Any person engaged in a trade or business is required to provide the information under Section 6050 I of the Internal Revenue Code.

Who Must File.—Each person engaged in a trade or business who, in the course of such trade or business, receives more than $10,000 in cash in one transaction (or two or more related transactions) must file Form 8300. For example, multiple receipts of cash from any person which in any one day total more than $10,000 should be treated as a single receipt (and therefore reportable).

Certain precious metals dealers, precious stones dealers, jewelry dealers, pawnbrokers, loan or finance companies, insurance companies and travel agencies are not excepted and must file Form 8300 when they have reportable cash transactions. To the extent that the Assistant Secretary of the Treasury (Enforcement and Operations) requires these financial institutions to file Form 4789, Currency Transaction Report, Form 8300 is not required to be filed for the same transaction(s).

Exceptions.—Financial institutions who are required to file IRS Form 4789 under Section 5312(a)(2)(A), (B), (C), (D), (E), (F), (G), (J), (K), (R), and (S) of Title 31, U.S.C., are excepted from filing Form 8300. These financial institutions include each agency, branch, or office in the United States of any person doing business in one or more of the capacities listed below:

(1) a bank (see Definitions);

(2) a broker or dealer in securities, registered or required to be registered with SEC under the Securities Exchange Act of 1934;

(3) a person who engages as a business in dealing in or exchanging currency (for example, a dealer in foreign exchange or a person engaged primarily in the cashing of checks);

(4) a person who engages as a business issuing, selling, or redeeming traveler's checks, money orders, or similar instruments, except one who does so as a selling agent exclusively, or as an incidental part of another business;

(5) a licensed transmitter of funds, or other person engaged in the business of transmitting funds abroad for others.

Transactions entirely occurring outside the United States are excepted from these reporting requirements, except to the extent regulations provide otherwise. The United States includes the 50 states and the District of Columbia.

When and Where to File.—File this form by the 15th day after the date of the transaction with the Internal Revenue Service Data Center, P.O. Box 32621, Detroit, MI 48232 ATTN: RCP or hand carry it to your local IRS office. Keep a copy of each Form 8300 for 5 years from the date you file it.

Identifying Number.—For individuals this is the social security number. For others it is the Federal employer identification number (EIN), which has 9 digits. For aliens or other non-U.S. individuals use the passport number or alien registration number and indicate the country.

Penalties.—Civil and criminal penalties are provided for failure to file a report or to supply information, and for filing a false or fraudulent report.

Statement to be provided.—A written statement must be provided to each person named in this form. The statement must be provided on or before January 31 of the year following the calendar year in which this report is made. The statement must show the name and address of the business receiving the cash and the total amount of cash received during the year from the payer and that the information is being furnished to the IRS. Keep a copy for your records. A copy of the Form 8300 that was filed with the Internal Revenue Service may be used as the statement if the payer had a single transaction for the year.

Specific Instructions

Part I

(1) For individuals, enter last name, first name, and middle initial, if any, in the name block in that order. For other than an individual, enter the complete organization name, address, and employer identification number in the boxes provided.

(2) In the social security block, enter the social security number of the individual conducting the transaction. If the individual has no number, write "None" in this block.

(3) If the individual is an alien or foreign national, enter the alien registration number or passport number and country or other official documents evidencing nationality or residence in the boxes provided.

(4) Complete the "Other identifying data" box for individuals other than aliens and foreign nationals. Other identifying information includes documents normally acceptable as a means of identification when cashing checks (e.g., a driver's license or credit card number may be entered in the "Other identifying data" box provided).

Part II

(1) In the address section, enter the permanent street address of the individual agent of the person in Part I conducting the transaction.

(2) In the social security block, enter the social security number of the individual conducting the transaction. If the individual has no number, write "None" in this block.

(3) If the individual is an alien or foreign national, enter the alien registration number or passport number and country or other official documents evidencing nationality or residence in the boxes provided.

(4) Complete the "Other identifying data" box for individuals other than aliens and foreign nationals. Other identifying information includes documents normally acceptable as a means of identification when cashing checks (e.g., a driver's license or credit card number may be entered in the "Other identifying data" box provided).

Part III

Enter in item 2 the amount of U.S. currency included in item 1 that is in $100 bills or higher. (For example, if the amount in item 1 is $30,000, and $25,000 of it was paid in $100 bills, enter $25,000 in item 2).

Check the applicable boxes that describe the nature of the transaction. Briefly describe the kind of property or service for which the customer paid cash.

If the aggregate amount of cash received in 2 or more installment payments exceeds $10,000, the date entered in item 5 should be the date the payment is made that caused the aggregate amount of cash to exceed $10,000.

Part IV

Signature.—This report must be signed by an authorized individual. Also type or print the name of the authorized signer below the signature.

Definitions

Bank.—Each agent, agency, branch, or office in the United States of a foreign bank and each agency, branch, or office in the United States of any person doing business in one or more of the capacities listed below:

(1) a commercial bank or trust company organized under the laws of any state or of the United States;

(2) a private bank;

(3) a savings and loan association or a building and loan association organized under the laws of any state or of the United States;

(4) an insured institution as defined in section 401 of the National Housing Act;

(5) a savings bank, industrial bank, or other thrift institution;

(6) a credit union organized under the laws of any state or of the United States; and

(7) any other organization chartered under the banking laws of any state and subject to the supervision of the bank supervisory authorities of a state.

Person.—An individual, corporation, partnership, trust or estate, joint stock company, association, syndicate, joint venture, or other unincorporated organization or group, and all entities treated as legal personalities, including organizations that are exempt from tax.

Cash.—The coin and currency of the United States or of any other country, which circulate in and are customarily used and accepted as money in the country in which issued. It includes United States silver certificates, United States notes, and Federal Reserve notes, but does not include bank checks, traveler's checks, or other negotiable or monetary instruments customarily accepted as money.

Transaction in Cash.—A transaction involving the physical receipt of cash from a person. A transaction in cash does not include a receipt of funds by means of bank check, bank draft, wire transfer, or other written order that does not include the physical transfer of cash.

Transaction.—The purchase of goods, services, personal or real property, and intangible property by a customer; a debt obligation paid for with cash; the receipt and conversion of cash to a negotiable instrument (for instance, a receipt of cash from a person in exchange for a check); and the receipt of cash to be held in escrow or trust.

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Mr. PICKLE. Mr. Edwards, are these two gentlemen speaking on the same point, or are they here to answer questions? I want to continue with your interrogation or go to these two gentlemen. Do you have separate statements?

Mr. TREANOR. We do not. On behalf of the National Association of Criminal Defense Lawyers, we would ask that the record reflect our endorsement of the statement by Mr. Edwards on behalf of the American Bar Association.

Mr. PICKLE. I appreciate your statement.

Mr. Heffernan, do you have any additional statement to make?

Mr. HEFFERNAN. No; I concur with what Mr. Treanor said on behalf of the National Association of Criminal Defense Lawyers. We endorse and support it.

Mr. PICKLE. Let me ask you some questions. I am sure that I can tell you what was the intent. I think the intent of this new provision is to stop the very thing you want to get an exception to, but you and I might differ on what was the intent of the Congress.

Suppose you had a client that offered you $10. You said if you had to get that name and address and social security number and report it that that would be in violation of the client and attorney relationship?

Mr. EDWARDS. Yes, sir.

Mr. PICKLE. That person could pay you by check, could they not? Wouldn't there be a record of that?

Mr. EDWARDS. Yes.

Mr. PICKLE. The example you gave me, the gentleman who wants to come and pay you in cash, doesn't that raise a red flag? If a man walked in and wanted to pay you $10,000?

Mr. EDWARDS. Not at all. There are many clients who want the fact that——

Mr. PICKLE. It sure would get my attention if I was practicing. I think it would. I am not an attorney, so I guess——

Mr. EDWARDS. Well, you say wouldn't it wave a flag? It would indicate to me as an attorney that my respective client was concerned about whatever legal problem he felt he had and wanted to keep its existence a matter of confidentiality between him and his lawyer.

Mr. PICKLE. Suppose that client came in and wanted to give you $100,000 in cash, would you want to maintain that same secrecy, that same client relationship?

Mr. EDWARDS. Mr. Chairman, depending on what the legal problem was. If the amount of fee the client wanted to pay me bore a logical relationship to the legal problem he thought he had, I don't think it would change the situation at all.

Mr. PICKLE. I am just trying to take it to the logical conclusion. Suppose he said, "I have got a big problem, I will pay $1 million for you to represent me."

Mr. EDWARDS. I wish he would come to see me soon.

Mr. PICKLE. You want him to come and I won't object to him coming to you. What the Government is trying to do is cause a reporting of funds that should be legitimately reported. We really were trying to avoid all this laundering of money, and it is appealing to look at the relationship of attorneys and others, but I have to ask myself, where is the end of this, how does it really work?

Let me ask you a question. Can an attorney, let's say in your case, could you sue your client in court for not paying fees without violating the attorney-client relationship?

Mr. EDWARDS. No; I can't, Mr. Chairman. After my representation of that client has ended, I have a right to sue him.

Mr. PICKLE. You say you can't do it.

Mr. EDWARDS. I can't as long as the attorney-client relationship exists, no. After that relationship terminates, if I say he owes me money, then I can sue him in court, and I believe the——

Mr. PICKLE. All you have to do is just say "I terminate this relationship" and sue, couldn't you do that?

Mr. EDWARDS. I could, I would say——

Mr. PICKLE. If he wasn't paying his bills and you thought you gave him good service, what would prevent you from saying "I have had enough of this, I have given you plenty of notice, and if you don't pay up by Friday, I am going to sue you on Monday," the relationship is broken and would be terminated?

Mr. EDWARDS. I would say that if the circumstances were such that my bringing the lawsuit against my former client would seriously jeopardize his rights or interests, then I wouldn't do it, and I think most lawyers wouldn't do it, I think it would be improper for a lawyer to do it.

Mr. PICKLE. I am not asking what you as an individual would do, I am not posing a moral question, if you can do that, as I understand you can, then I would say that I would have to say there would be some question of consistency of your position. You want to maintain a relationship, and yet you want to break it off and go forward in a different direction.

On the other hand, I would say, I am trying to see what would be fair. I don't think any of us in Congress wants you to betray the confidence that that client would want to keep with you, I know I don't and I don't think the members would. But we are asking for reporting over and above the $10,000 figure. You have to ask yourself is it laundered money, or what is it?

Mr. EDWARDS. I think I need to make a couple of comments. Mr. Treanor may have some other thoughts to add. No. 1, the obligation that is placed upon the attorney by the code of ethics, canon of ethics, code of professional responsibility is something that every attorney has to interpret as he or she believes is appropriate, and I would interpret the obligations to protection of any client's confidentiality and to not act in a way contrary to his interest to be superior to my interest in collecting my fee and as long as those two were in conflict, I think it would be unethical for me or any lawyer to attempt to collect a fee.

No. 2, I would suggest that it is not at all laundering money, it is simply recognizing that our system guarantees the availability of legal services to our citizens, and even regardless of the circumstances under which the citizen feels he needs legal representation, it is not laundering money at all for the citizen to be able to get legal counsel, competent legal counsel, to represent him on his legal problem, by paying in cash or any other lawful means, and when because the Government still presumes any citizen, accused or not yet accused, innocent and because of all of the other fundamental principles of our system of justice, I think it is a very dan-

gerous step to place the desirability of revenue collection above the availability of legal services, legal representation to our citizens.

So I would suggest that it is not money laundering at all to permit citizens within the framework of confidentiality to pay cash to their lawyers for legal fees, because that lawyer is going to deposit that money, and that money will be reported. Through the present bank currency reporting requirements of title 31, section 5312, that money is going into the system, the Government is going to know immediately that the lawyer received it, and deposited it. The only thing that will be kept from the Government is the confidential relationship that we have always protected.

Mr. PICKLE. Well, assume that the attorney will report it, he should report it, we don't know that he will, we know if we make that requirement, he sure will.

Mr. EDWARDS. If he doesn't, he should be prosecuted for not——

Mr. PICKLE. This way, he knows that is simply an "A-B-C" thing to do, and he is going to report it. I don't know, laundering money sounds like we are talking about illegal or improper money. Sometimes I guess it is not dope or illegal traffic, you can argue about what laundering money is. We do recognize this is going on in the real world and is taking place.

The President's Commission on Organized Crime in its first report said that attorneys do accept significant amounts of cash for laundered money from organized crime. They make that as a finding, that is one of the reasons that prompted this requirement. Here is the President's Commission on Crime saying this is taking place and recommending changes be made. So I am asking you, is your statement representing the defense function of the criminal justice system, or is it the official position of the American Bar Association?

Mr. EDWARDS. Mr. Chairman, it is the official position of the American Bar Association. The criminal justice section of the American Bar recommended this resolution to the house of delegates of the ABA and after debate and careful consideration, it was adopted as American Bar Association policy, and it represents a very thoughtful and careful consideration of a balancing of interests here, and I would suggest to you, Mr. Chairman, that the point of view that was represented by the Prsident's Commission is an extraordinarily, jaded, inaccurate, unfair, and cynical point of view. The lawyers around——

Mr. PICKLE. I must say that is pretty good language.

Mr. EDWARDS. You invited me to take them on, I would be happy to discuss it with them. The defense, the poorest lawyers in this country are the lawyers that spend a lot of their time defending people accused of crime and make sacrifices to do it, and they do it because they believe in it. I started out for myself as an assistant State prosecutor, then I went into private practice, because I believe in the way our system is supposed to work. I think it is a remarkable system. It is a system that respects the integrity of individual citizens and it hurts me to see anything happen to break down the respect and the priority on individual freedom and integrity that our system has always had.

And, frankly, Mr. Chairman, I don't deny for a moment that there have been some lawyers that engaged in unethical conduct,

even illegal conduct. I would hate to see the fundamental premises of our system scrapped just because of a few, a very few lawyers.

Mr. PICKLE. I am trying to get a little background on this.

Mr. EDWARDS. I am delighted that you are, believe me.

Mr. PICKLE. Suppose a client comes to you, and you make arrangements with him and he pays you $12,000.

Mr. EDWARDS. All right, sir.

Mr. PICKLE. Do you report that then to the bank?

Mr. EDWARDS. Oh, yes, I certainly do.

Mr. PICKLE. Your name or his name?

Mr. EDWARDS. In my name.

Mr. PICKLE. He is never involved in it, but it is reported that way.

Mr. EDWARDS. Absolutely, under the bank reporting laws, as soon as I take that money to deposit to my firm's account, it is reported that my firm has earned that money.

Mr. PICKLE. That would be true whether you got a fee of $50,000 or $100,000 or $1 million, it all goes in your name and not in the individual's name?

Mr. EDWARDS. That is correct.

Mr. PICKLE. Suppose the individual goes directly to the bank, says "I want to make this deposit," the bank then has to report it, does it not?

Mr. EDWARDS. If the individaul client does?

Mr. PICKLE. Yes.

Mr. EDWARDS. If the client deposits the money in the bank, the bank reports his name and Social Security number. Do I understand your question?

Mr. PICKLE. Suppose that your client, instead of coming to you, went directly to the bank and made that deposit in excess of that amount, would not the bank then report that?

Mr. EDWARDS. Yes, sir. It certainly would. It would report it under the name of the person making the deposit.

Mr. PICKLE. Well, we have to assume, then, that the lawyer who makes this relationship of client and the attorney and pays you in excess of that amount, that that attorney will make that report.

Mr. EDWARDS. Yes, sir, I think you can assume that, that is the law. And a lawyer——

Mr. PICKLE. We have indication that isn't being done, and there is no question raised about it, there is no attempt to find the validity of the source of those funds, we need that reporting, we are trying to trace the source of money, if it comes to a client, to an attorney, there is no check except on you, as an attorney, and you are not going to tell them where you get that, because you are protecting that relationship. You wouldn't tell them under oath or anything else; that is what you are pledged to do.

Now if, in case of E.F. Hutton, people were bringing in these laundry bags of money and counting it out in $20 bills. At least we can go back and check the source of the money. If we go through the attorneys, it seems like we lose the ability to check back, even though you say you do report it. So how do we get our hands on stopping some of the flow of money that ought to be officially reported, at least to determine whether it is legal?

Mr. EDWARDS. Mr. Chairman, I would suggest that the amount of money that would be or is being paid in cash for attorneys' fees is minuscule in relation to the money that the Government has a legitimate interest in getting a handle on that is being spent to buy big new cars or jewels or fur coats or vacations, or what have you. So what you are giving up, I would suggest, is next to nothing. What you are gaining by granting this exemption is maintaining a guarantee of confidentiality that has existed as long as the United States has.

I think the tradeoff is well worth it because, as we have discussed, that money is going to be reported when the lawyer deposits it and reports it, and if the lawyer doesn't act properly, then that lawyer ought to be prosecuted for violating the law. It is that impropriety that ought to be attacked by the law, and present law reaches that now.

Mr. PICKLE. I would agree with you he ought to be prosecuted. But it is going to be hard to know how to prosecute him if he didn't report it. What we are trying to say, is that you do have to report it.

Mr. EDWARDS. Well, I would say, Mr. Chairman, if he doesn't report and goes out and spends it, if he buys anything very big, then he is going to fall within the scope of 6050(i), and the Government will find out about it.

Mr. PICKLE. He might, and we don't want Congress to try to act as a policeman, we have other things to be doing. We decide that we are trying to say what is a proper way to control the flow of money in this country, and we have said, that above this amount, it ought to be reported.

Mr. EDWARDS. I understand.

Mr. PICKLE. And you are asking now for an exemption for the attorney.

Mr. EDWARDS. For the attorney-client relationship, not the lawyers that should be protected, it is the existence of the relationship.

Mr. PICKLE. I think these are things that the committee ought to take into consideration, and I can understand your viewpoint on it. I am just trying to understand a little bit better myself.

Mr. EDWARDS. I am very grateful for your questions.

Mr. PICKLE. I thank both of you. Do you have something else?

Mr. TREANOR. Mr. Chairman, I would only like to make the point, so it is clear in the record, that the $10,000 payment is somewhat deceiving because that is not the threshold of reporting. As a matter of fact, regardless of what the individual payments are as soon as those payments total $10,000, regardless of how long the relationship has existed, between the attorney and the client, there is then an affirmative obligation on the part of the attorney under the provisions that we seek to have amended to make the reporting. So that the person who has been paying the lawyer in cash over a period of time, amounts that eventually accumulate to $10,000, must be reported.

Mr. PICKLE. You make a point there, I didn't realize that. I thank you gentlemen, if you want to submit any additional statements, we will be pleased to receive them, and we may have additional questions for you.

Mr. EDWARDS. We would be delighted. Thank you for hearing us today.

Mr. TREANOR. Thank you.

Mr. HEFFERNAN. Thank you, Mr. Chairman.

I think we have one more item that was on the panel, we took the last group just ahead of the group on piggyback excise tax.

Mr. PICKLE. All right. You are talking about the railroad piggyback equipment question.

Mr. HEFFERNAN. Yes, sir.

Mr. PICKLE. Do we have Mr. Kenny and Mr. Wickham; or Mr. Heffernan, you are with this group too?

Mr. HEFFERNAN. Yes, sir, I am.

Mr. PICKLE. All right, Mr. Heffernan.

Mr. HEFFERNAN. Let me introduce Mr. Dennis Kenny, who will make a statement on behalf of the ad hoc group with his counsel, Dale Wickham. I am serving as cocounsel. Thank you, Mr. Chairman.

STATEMENT OF DENNIS J. KENNY, CHAIRMAN, AD HOC GROUP OF SUPPLIERS AND USERS OF RAILROAD PIGGYBACK EQUIPMENT AND VICE PRESIDENT AND GENERAL COUNSEL, TRANSAMERICA INTERWAY, ACCOMPANIED BY DALE W. WICKHAM, COUNSEL TO THE AD HOC GROUP, AND EDWARD D. HEFFERNAN, COCOUNSEL

Mr. PICKLE. Mr. Kenny, you are the one who is going to make the statement?

Mr. KENNY. Yes, sir.

Mr. PICKLE. You may proceed.

Mr. KENNY. I am vice president and general counsel of Transamerica Interway, the Nation's largest owner of railroad piggyback equipment. I am here today in my capacity as chairman of an ad hoc group of suppliers and railroad users of railroad piggyback equipment. With me to answer questions are Dale Wickham and Ed Heffernan, counsel and cocounsel to the group respectively.

Mr. Chairman, and members of the committee, I thank you for the opportunity to appear today in support of an amendment to H.R. 1800 to correct a technical defect in code section 4051(d). This technical defect causes the excise tax rate reduction intended by Congress for railroad piggyback equipment to operate instead as a mere tax deferral.

As background, section 4051 of the code generally imposes a 12-percent excise tax on the first retail sale of heavy trucks and trailers. Many vehicles, such as rail vans, trash containers, concrete mixers and certain farm equipment, are exempt from the tax because of their limited highway use. As part of the Tax Reform Act of 1984, in recognition of the limited highway use and preponderantly nonhighway use of railroad piggyback equipment, Congress enacted a temporary 1-year reduction, from 12 to 6 percent, in the rate of tax imposed on the first retail sale of railroad piggyback equipment, while directing further study as to the appropriate level and application of the tax on railroad piggybacks for the future. The rate reduction for railroad piggyback is contained in a new subsection (d) to code section 4051.

Paragraph (3) of code section 4051(d) defeats the congressionally intended rate reduction for piggybacks by imposing an additional 6 percent tax on the original purchase price of a railroad piggyback if it is at any time used or resold for use other than principally in rail service. There is no time limit on which the use conversion must occur to trigger the additional tax.

Furthermore, such additional tax is based on the original cost of the equipment, not on its value at the time of conversion. Obviously, railroad piggybacks eventually must either be scrapped or converted to nonrailroad use, such as storage or local transportation, but typically not until they have been used for many years in railroad piggyback service. Thus, the provision as presently drafted erroneously converts what was intended to be a tax reduction into a tax deferral.

To remedy this defect, we recommend repeal of the provision imposing the additional tax on use conversion. Such a repeal would be consistent with treatment for other categories of equipment that are totally exempt from the tax. It should be noted that the rate reduction is not available for a railroad piggyback in the first instance unless three conditions are satisfied: One, it is actually designed principally for rail flatcar service; two, it meets the AAR performance specifications for certification for rail piggyback service—see attachment A to my written statement for illustrations and descriptions of the AAR requirements; in the written statements that I have submitted we have some photographs and illustrations with regard to the types of specifications that are required for piggyback trailers; three, the purchaser signs a certificate as to intended rail use. A false certificate could subject the user to serious criminal penalties. Thus, this unusual certificate requirement already provides adequate protection.

Alternatively, if some additional tax were nevertheless retained for possible use conversion, a pair of limits, both as to time and amount of additional tax, should be imposed. First, in no event should the additional tax be imposed unless the use conversion occurs before expiration of a minimum period, such as 6 months to 2 years after the piggyback is originally placed in service. Second, the amount of any additional tax should be limited so that the additional tax, together with any tax previously paid, cannot exceed 12 percent of the value of the piggyback at the time of conversion principally to highway use.

Finally, the corrective amendment should be made effective as if included in the original rate reduction provision.

We would be pleased to respond to any questions you may have.

[The prepared statement follows:]

Statement of Dennis J. Kenny, Chairman of an Ad Hoc Group of Suppliers and Railroad Users of Railroad Piggyback Equipment

SUMMARY

1. On behalf of an ad hoc group which includes suppliers and railroad users of railroad piggyback equipment, I support an addition to H.R. 1800 to correct a technical defect in Code section 4051(d), which correction would make the reduction in rate for railroad piggyback equipment under the Federal excise tax imposed on the first retail sale of heavy trucks and trailers operate as the rate reduction intended instead of as a mere deferral.

2. To remedy the defect, I recommend repeal of paragraph (3) of Code section 4051(d), which imposes an additional tax on use conversion.

3. Alternatively, if some additional tax were nevertheless retained for conversion to highway use, a pair of limits on both the time for application of the additional tax and the amount of additional tax should be imposed, pursuant to which (1) no additional tax would be imposed if a railroad piggyback were used principally in trailer-on-flatcar service by rail for a minimum period (which could range from 6 months to 2 years), and (2) the additional tax (in the event of a conversion of use before expiration of the minimum period) would be limited so that the entire tax paid (considered together with the tax previously paid on the first retail sale of the railroad piggyback) would not exceed 12% of resale or fair market value at the time of use conversion.

4. To effectuate the Congressionally intended rate reduction, the corrective technical amendment should be made effective as if included in the railroad piggyback rate reduction provision upon its original enactment in 1984, so that the provision as amended applies to any sale of a railroad piggyback made after July 17, 1984.

STATEMENT

Mr. Chairman, Members of the Committee, I thank you for the opportunity to testify today in support of an addition to H.R. 1800 to correct a technical defect in Code section 4051(d). The correction would make the reduction in rate for railroad piggyback equipment provided under the Federal excise tax on the first retail sale of heavy trucks and trailers operate as the rate reduction intended by Congress instead of as a mere deferral.

Although I am Vice-President and General Counsel of Transamerica Interway, Inc.,*/ the Nation's largest owner of railroad piggyback equipment, I am appearing here today in my capacity as chairman of an ad hoc group of suppliers of railroad piggyback equipment and railroads who use such equipment. Companies supporting the goals of the ad hoc group

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*/ Transamerica Interway, Inc., 522 Fifth Avenue, New York, New York 10036, (212) 719-9700

include, among the railroad piggyback equipment suppliers, Transamerica Interway and BRAE Corporation, and among the railroad users, the Southern Pacific Transportation Company, the Atchison, Topeka, Santa Fe Railroad Company, the Chessie System Railroad, Burlington Northern Railroad, Norfolk Southern Corporation, Chicago and Northwestern Transportation Company and Seaboard System Railroad. Accompanying me today are Mr. Dale Wickham,* Counsel to the ad hoc group, and Mr. Edward Heffernan,** who is co-counsel to the group.

As background, section 4051 of the Internal Revenue Code was enacted as part of the Highway Revenue Act of 1982. The Act converted the prior law 10% manufacturers' excise tax on trucks to a 12% retail tax on heavy trucks and trailers, effective April 1, 1983. The prior tax applied to truck chassis and bodies weighing more than 10,000 pounds. The new retail tax imposed by section 4051 applies only to trucks weighing more than 33,000 pounds and trailers weighing more than 26,000 pounds.

The rationale for the change is clear: heavy trucks and trailers which make extensive use of the Nation's highways cause considerably greater damage to the highways than lighter

---

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vehicles or vehicles used primarily in non-highway functions, and are accordingly required to pay more tax for maintenance of the highways. Consistent with the Congressional purpose of restructuring and shifting the burden of the retail excise tax to the heaviest and most extensive highway users, not only was the weight threshold for imposition of the tax significantly increased; Congress also exempted many articles that are suitable for highway use but which are in fact primarily designed for use and primarily used in nonhighway functions. Included in the list of exempt articles are rail vans, trash containers, concrete mixers, and certain farm equipment.

As part of the Tax Reform Act of 1984, in recognition of the limited highway use and the preponderantly non-highway use of railroad piggyback equipment, Congress enacted (by adding a new subsection (d) to section 4051) a temporary reduction, from 12% to 6%, in the rate of tax imposed on the first retail sale of railroad piggybacks. This temporary reduction applies to sales during the 1-year period beginning July 18, 1984, and ending July 17, 1985, with direction for a study to be conducted by the Department of Transportation (in consultation with the Treasury Department) as to the appropriate application and level of the tax on railroad piggybacks, and for a report on the study, with recommendations, to be submitted to Congress by May 1, 1985.

This rate reduction applies to a trailer or semitrailer "designed for use principally in connection with trailer-on-flatcar ["TOFC"] service by rail," but only if the seller and purchaser are properly registered with the Internal Revenue Service, and then only if the purchaser certifies to the seller, at the time and in the manner required by Treasury Regulations, that the trailer or semitrailer "will be used principally" in TOFC service by rail. The certificate required by the Regulation makes clear that a false certification, in addition to other sanctions, subjects the signer to criminal penalties. Thus, the required certificate provides immediately above the signature that --

> "I understand that the willful use of this certificate to evade or defeat the excise tax otherwise applicable under section 4051(a), will subject me to a fine of not more than $10,000 or imprisonment of not more than 5 years, or both, together with cost of prosecution."

Paragraph (3) of Code section 4051(d) defeats the Congressionally intended rate reduction for railroad piggybacks by imposing an additional tax of 6% of the original purchase price of a railroad piggyback if it is at any time used or resold for use other than principally in TOFC service. There is absolutely no time limitation within which such use conversion may occur for the additional tax to be triggered. Railroad piggybacks will eventually be scrapped or resold for use other than principally in TOFC service (e.g., storage,

local transportation, etc.), but typically not until they have been used for many years in TOFC service. Thus, section 4051(d) as presently drafted erroneously converts what was intended to be a tax reduction into a tax deferral.

To remedy this defect, we recommend repeal of the provision in paragraph (3) of Code section 4051(d) imposing an additional tax on use conversion. The additional tax imposed by paragraph (3) on a change in the equipment's use after the original taxable sale is not necessary, and is, in fact, punitive when compared to other excise tax exemptions or rate reductions. Thus, the seven other categories of equipment exempted from this tax under the provisions of Code section 4053 make the availability of the exemption depend on the designed use of the equipment as of the time of the taxable sale -- without even requiring a certificate of such designed use to be executed under criminal penalties. That approach has the desirable effect of eliminating the problems of enforcement for the IRS and of compliance by taxpayers that result from causing a determination that must be made at the time of the sale to be changed later on by reason of facts as to actual use after the sale. The criminal and other sanctions imposed for falsification by a purchaser of the unusual certificate required as to the intended use of a railroad piggyback should be sufficient additional protection, without adding the administrative and compliance costs and burdens associated with

continuous after-sale monitoring and tax reporting on uses of equipment.

Alternatively, if some additional tax were nevertheless retained for conversion to highway use, a pair of limits on both the time for its application and its amount should be imposed to help correct the error. Thus, the time for imposition of any additional tax should be limited so that there would be no additional tax if a railroad piggyback were used principally in TOFC service by rail or other non-highway use for a significant minimum period, which could be from as little as 6 months to as much as 2 years. For example, this change in the statute could be accomplished as follows:

> Amend the first clause of paragraph (3) of Code section 4051(d) by inserting immediately after "paragraph (2)" the following: "within 1 year of the date such trailer or semitrailer is placed in service".

The amount of any additional tax also should be limited so that such additional tax, when considered together with the tax previously paid on the first retail sale of railroad piggyback, will not exceed 12% of its resale or fair market value at the time of its conversion to a disqualifying use. Such a change would achieve the proper result of limiting the imposition of the full rate of tax only to the value of the equipment at the time of its conversion to the highway uses appropriately covered by the tax. Such a limitation on the amount of any additional tax can be accomplished as follows:

Amend subparagraph (B) of paragraph (3) of section 4051(d) to read as follows:

> "(B) the amount of the tax imposed under subsection (a) on such sale shall be equal to 12% of the amount for which the trailer is so resold (or in the case of a trailer which is not so resold but which is used for a use other than a use described in paragraph (2), 12% of the fair market value of the trailer determined at the time of such change in use), reduced (but not below zero) by the amount of tax previously imposed under subsection (a) with respect to such trailer."

To effectuate the Congressionally intended rate reduction, the corrective technical amendment should be made effective as if included in the railroad piggyback rate reduction provision upon its original enactment in 1984, so that the provision as amended applies to any sale of a railroad piggyback made after July 17, 1984.

As additional background, included with my statement as Attachments are:

(A) A descriptive and illustrative compilation of data and photographs entitled "Components Required on AAR Certified Railroad Piggybacks and Not Found on Over-The-Road (OTR) Trailers", and

(B) A document entitled "Comments and Legislative Recommendations Concerning Appropriate Application and Level for Railroad Piggyback Equipment of Federal Excise Tax Imposed by Internal Revenue Code Section 4051 on First Retail Sale of Heavy Trucks and Trailers".

Attachment B, in addition to recommending adoption of the technical amendment urged in this statement, recommends that the reduction in the retail excise tax rate for railroad piggybacks be made permanent -- that is, until the tax itself expires on September 30, 1988 -- at a level of not more than 3% for sales on and after July 18, 1985.

We shall be pleased to respond to any questions you may have about this.

* * *

COMPONENTS REQUIRED ON AAR CERTIFIED RAILROAD PIGGYBACKS AND NOT FOUND ON OVER-THE-ROAD (OTR) TRAILERS

PREPARED BY

TRANSAMERICA INTERWAY INC.

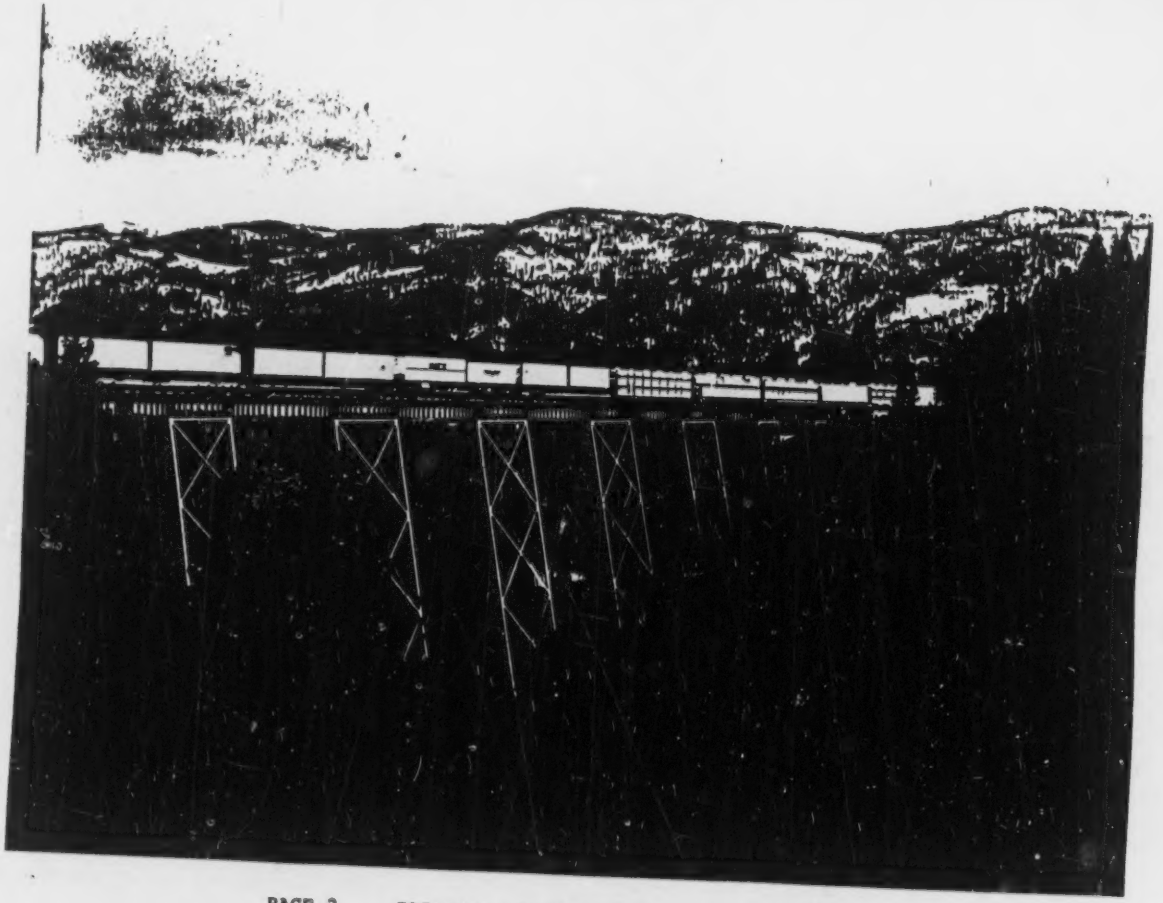
JAMES L. DAVIES
VICE PRESIDENT
TECHNICAL SERVICES

MAY 1, 1985

WEIGHT AND COST OF COMPONENTS REQUIRED ON AAR CERTIFIED RAILROAD PIGGYBACKS AND NOT FOUND ON OVER-THE-ROAD (OTR) TRAILERS

COMPONENT		REMARKS	AVE. ADDED WEIGHT	AVE. ADDED COST WITHOUT FEDERAL EXCISE TAX **
1. LIFT PADS	*	REQUIRED FOR BOTTOM RAIL PROTECTION WHEN LIFTING RAILROAD PIGGYBACK ONTO FLATCAR.	280 lbs.	$226
2. STANCHION PLATE	*	REQUIRED TO PROTECT UNDERSIDE OF RAILROAD PIGGYBACK WHEN POSITIONING IT ON FLATCAR.	55 lbs.	$ 37
3. EXTRA DOOR HARDWARE	*	4 HEAVY DUTY LOCKING BARS ON RAILROAD PIGGYBACK DOOR VS. 2 LIGHT DUTY LOCKING BARS ON OTR TRAILER DOOR.	106 lbs.	$113
4. EXTRA DOOR THICKNESS	*	1 1/4" THICK PLYMETAL DOOR WITH 10 HEAVY DUTY HINGES ON RAILROAD PIGGYBACK VS. 3/4" THICK DOOR WITH 6 HINGES ON OTR TRAILER.	165 lbs.	$265
5. FRONT CONSTRUCTION	*	HEAVY DUTY FRAME CONSTRUCTION WITH 3/4" THICK PLYWOOD LINER ON RAILROAD PIGGYBACK VS. LIGHT DUTY FRAME CONSTRUCTION AND 1/4" THICK PLYWOOD LINER ON OTR TRAILER. ALSO, FITTINGS ON RAILROAD PIGGYBACK MUST BE RECESSED AND A MANIFEST HOLDER MUST BE INSTALLED.	138 lbs.	$120
6. SIDE POSTS		HEAVY DUTY SIDE POSTS ON RAILROAD PIGGYBACK PLUS ONE EXTRA OVER LANDING GEAR AND ONE OVER TANDEM.	164 lbs.	$ 76
7. LANDING GEAR	*	HEAVY DUTY SUPPORT MEMBERS ON RAILROAD PIGGYBACK.	30 lbs.	$ 25
8. KING PIN ASSEMBLY		HEAVIER PICK-UP PLATE, HARDER KING PIN AND STRONGER SUPPORT MEMBERS ON RAILROAD PIGGYBACK.	60 lbs.	$ 51
9. SUSPENSION		4 PIN SLIDE ASSEMBLY ON RAILROAD PIGGYBACK VS. 2 PIN ASSEMBLY ON OTR TRAILER.	75 lbs.	$ 20
TOTAL			1073 lbs.	$933

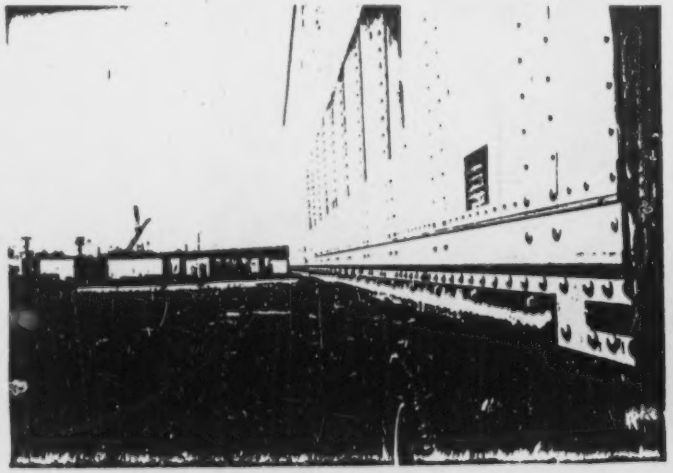
* SEE PHOTOGRAPHS ON FOLLOWING PAGES. ** TYPICAL COSTS SUPPLIED BY TRAILER MANUFACTURERS - COMPILED IN NOVEMBER 1984.



PAGE 2 RAILROAD PIGGYBACKS TRAVELING ON FLAT CARS

1. LIFT PADS

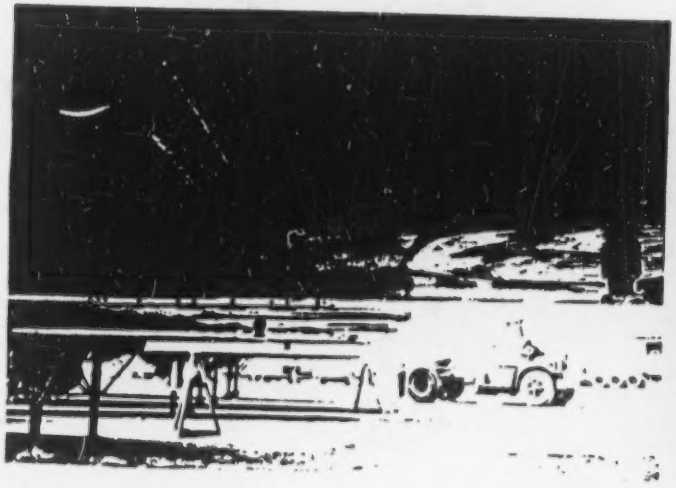
CONSIST OF STEEL ANGULAR SECTIONS FASTENED TO THE BOTTOM RAILS AND CROSS MEMBERS OF THE RAILROAD PIGGYBACKS SO AS TO PROTECT ITS BOTTOM STRUCTURE WHEN BEING LIFTED ON OR OFF A FLAT CAR BY PIGGYPACKER OR CRANE. REQUIRED FOR AAR CERTIFICATION.

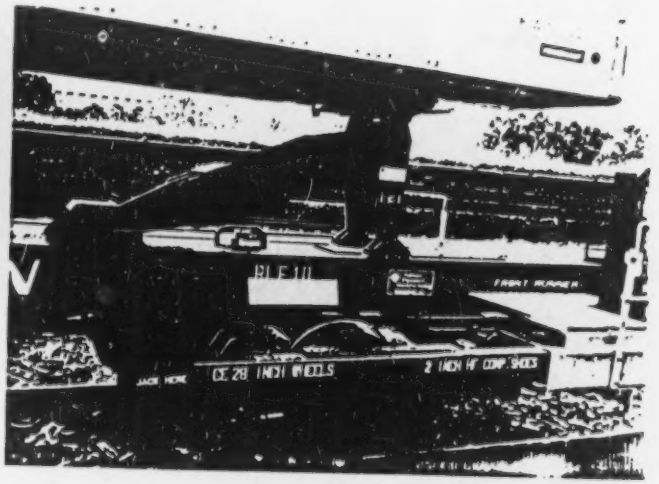


(NOT REQUIRED ON OTR TRAILER)

2. STANCHION PLATE

CONSISTS OF AN 18" WIDE STEEL PLATE EXTENDING AFT OF THE KING PIN PLATE OF A RAILROAD PIGGYBACK. ITS PURPOSE IS TO PREVENT SNAGGING OF THE ADJACENT CROSS MEMBERS WHEN ENGAGING THE RAIL CAR HITCH (OR STANCHION) WITH THE RAILROAD PIGGYBACK'S KING PIN. REQUIRED FOR AAR CERTIFICATION.





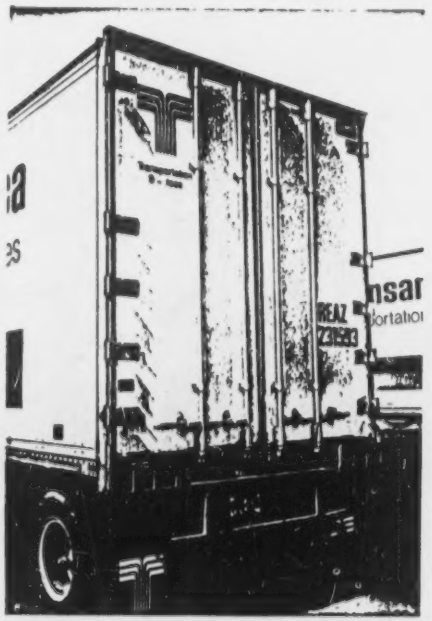
425

(NOT REQUIRED ON OTR TRAILER)

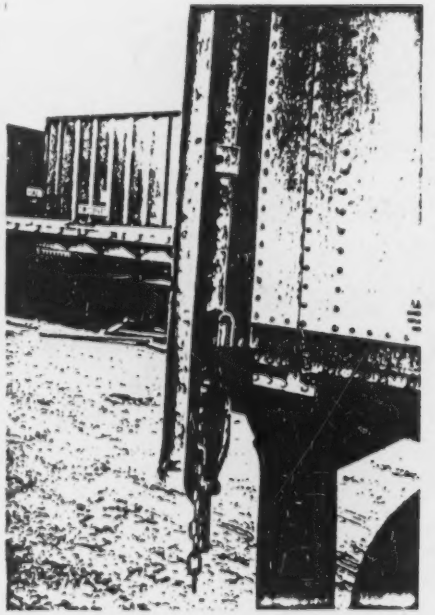
3. & 4. EXTRA DOOR HARDWARE AND DOOR THICKNESS

THE RAILROAD PIGGYBACK MUST BE BUILT TO WITHSTAND HEAVY CARGO IMPACT LOADS AT THE FRONT WALL AND REAR DOORS WHEN THE RAIL CARS ON WHICH THEY RIDE ARE BEING COUPLED OR BRAKED. THIS REQUIRES EXTRA HINGES (10) AND LOCKING BARS (4) - ALL HEAVY DUTY, AT THE REAR. ALSO AAR SPECIFIED DOOR THICKNESS MUST BE 1¼". THIS COMPARES WITH A TYPICAL OTR TRAILER HAVING LIGHT DUTY HINGES (6), LOCKING BARS (2) AND DOOR THICKNESS (3/4").

RAILROAD PIGGYBACK - REAR DOORS



4 LOCKING BARS
10 HINGES

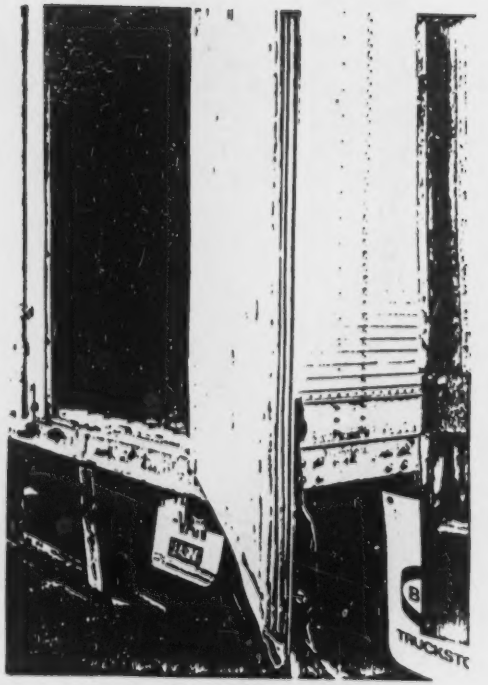


1¼" DOOR THICKNESS

3. & 4. (CONTINUED)

OTR TRAILER - REAR DOORS

2 LOCKING BARS
6 HINGES



3/4" DOOR THICKNESS

5. FRONT CONSTRUCTION

TO WITHSTAND THE HEAVY CARGO IMPACT, THE FRONT CONSTRUCTION OF A RAILROAD PIGGYBACK IS USUALLY CONSTRUCTED OF 6 HEAVY DUTY VERTICAL POSTS (OUTLINED IN THE PHOTO BY RIVET HEADS) AND AN INTERIOR LINING (NOT SHOWN) OF 3/4" PLYWOOD. ALSO A METAL MANIFEST (DOCUMENT) HOLDER MUST BE PROVIDED.

RAILROAD PIGGYBACK

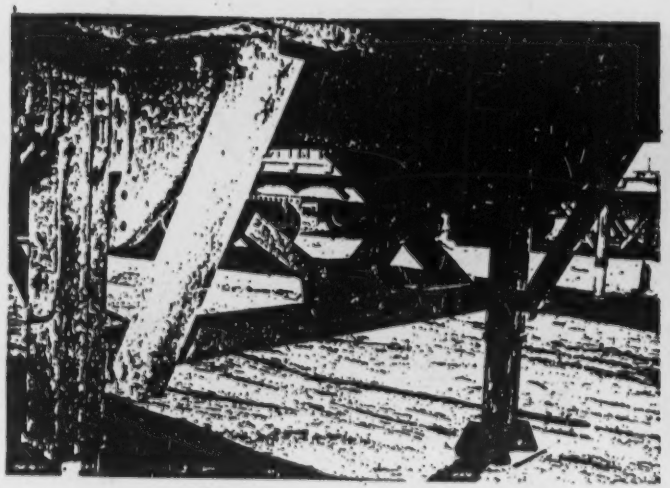
OTR TRAILER

FOUR POSTS,
1/4" INTERIOR PLYWOOD LINING,
NO MANIFEST HOLDER

7. LANDING GEAR

RAILROAD PIGGYBACKS REQUIRE HEAVY DUTY LANDING GEAR TO SUPPORT THE TRAILER AS IT IS UNLOADED FROM THE RAIL CAR AND SET DOWN ON THE CROUND BY THE PIGGYPACKER OR CRANE.

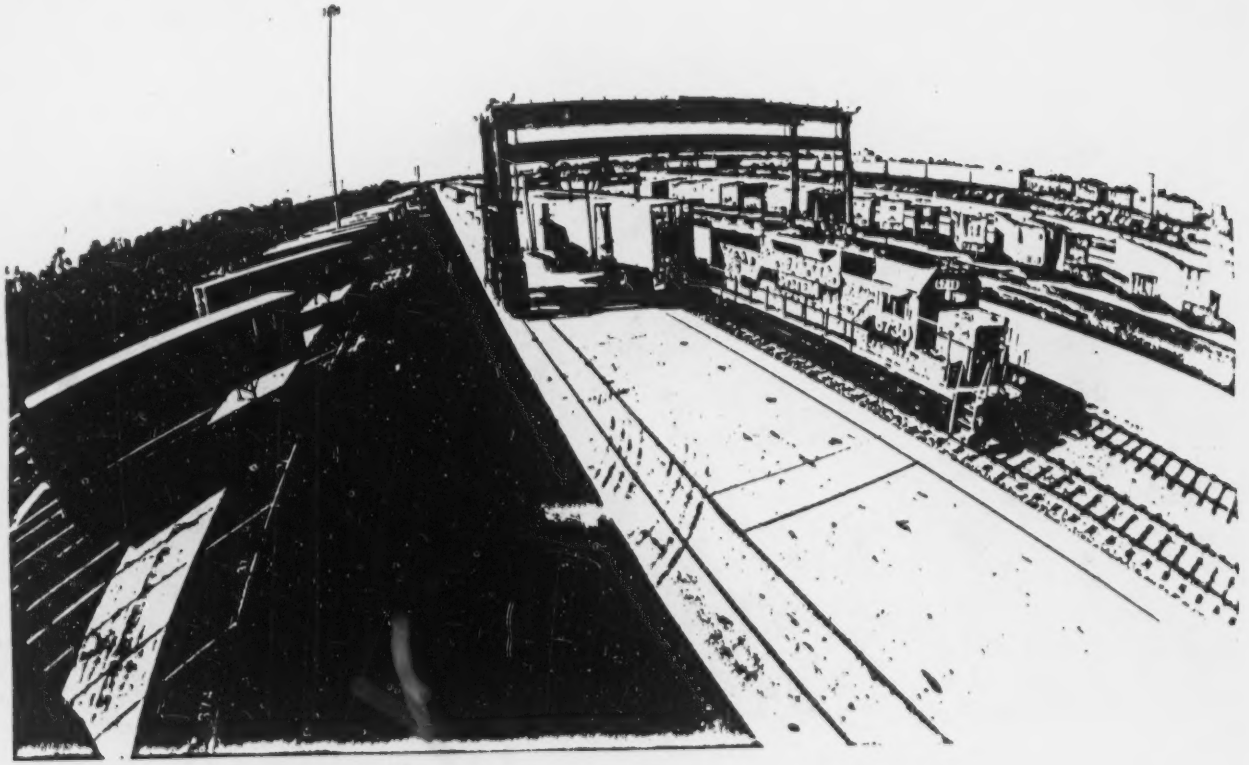
RAILROAD PIGGYBACK



HEAVY DUTY SUPPORT MEMBERS
(WITH BRACING FORE, AFT, CROSS
AND DIAGONAL TO MEET AAR
TEST REQUIREMENTS)

OTR TRAILER

LIGHT DUTY SUPPORT MEMBERS



PAGE 9 RAILROAD PIGGYBACKS BEING LOADED ONTO FLAT CARS

ATTACHMENT B

COMMENTS AND LEGISLATIVE RECOMMENDATIONS CONCERNING APPROPRIATE APPLICATION AND LEVEL FOR RAILROAD PIGGYBACK EQUIPMENT of FEDERAL EXCISE TAX IMPOSED BY INTERNAL REVENUE CODE SECTION 4051 on FIRST RETAIL SALE OF HEAVY TRUCKS AND TRAILERS

Submitted

On behalf

of

an ad hoc group

of

Suppliers and Railroad Users of Piggyback Equipment
including
Santa Fe Southern Pacific Corporation
Atchison, Topeka, Santa Fe Railroad Company
Transamerica Interway Inc.
BRAE Corporation

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May 10, 1985

COMMENTS AND LEGISLATIVE RECOMMENDATIONS CONCERNING APPROPRIATE APPLICATION AND LEVEL FOR RAILROAD PIGGYBACK EQUIPMENT OF FEDERAL EXCISE TAX ON FIRST RETAIL SALE OF HEAVY TRUCKS AND TRAILERS

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May 10, 1985

COMMENTS AND LEGISLATIVE RECOMMENDATIONS
CONCERNING APPROPRIATE APPLICATION
AND LEVEL FOR RAILROAD PIGGYBACK
EQUIPMENT OF FEDERAL EXCISE TAX ON FIRST
RETAIL SALE OF HEAVY TRUCKS AND TRAILERS

This paper examines the policy considerations relating to the excise tax imposed on the first retail sale of heavy trucks and trailers by section 4051 of the Internal Revenue Code of 1954, and the relationship of that policy to the appropriateness of an exemption or lower rate of tax for railroad piggyback equipment.

This paper concludes with legislative recommendations as follows:

(1) to appropriately reflect the low percentage of highway use by railroad piggybacks, a reduced rate of tax for railroad piggybacks should be continued at a rate reduced to not more than 3% for sales on and after July 18, 1985, and

(2) a technical legislative correction (effective as to sales on and after July 18, 1984) is necessary to carry out Congressional intent to provide a rate reduction instead of a mere deferral of the tax for railroad piggybacks.

I. DISCUSSION

(a) Brief Legislative History of, and Policy Behind, Enactment of This Federal Excise Tax (Code section 4051)

Section 4051 of the Internal Revenue Code was enacted as part of the Highway Revenue Act of 1982. (See Appendix A

for copy of section 4051 as amended to date.) The Act converted the prior law 10% manufacturers' excise tax on trucks to a 12% retail tax on heavy trucks and trailers, effective April 1, 1983. The prior tax applied to truck chassis and bodies weighing more than 10,000 pounds. The new retail tax imposed by section 4051 applies only to trucks weighing more than 33,000 pounds and trailers weighing more than 26,000 pounds.

The rationale for the change is clear: heavy trucks and trailers which make extensive use of the Nation's highways cause considerably greater damage to the highways than lighter vehicles or vehicles used primarily in non-highway functions, and therefore should pay more tax for maintenance of the highways. This policy is enunciated in the House Ways and Means Committee Report accompanying the Bill that was ultimately enacted as the Highway Revenue Act of 1982. The report states:

> "In light of testimony presented before the committee to the effect that the costs of future highway improvements would be unfairly distributed if the current manufacturers excise tax on trucks were not modified, the committee believes that this tax should be restructured to yield no tax or a lower tax for lighter vehicles and a higher tax for heavier vehicles. H. Rept. No. 97-945, 97th Cong., 2d Sess., p.14.

Consistent with the Congressional purpose of restructuring and shifting the burden of the retail excise tax to the heaviest and most extensive highway users, not only was the

weight threshold for imposition of the tax significantly increased; Congress also exempted many articles that are suitable for highway use but which are in fact primarily designed for use and primarily used in nonhighway functions. Included in the list of exempt articles are rail vans. Notwithstanding that rail vans exceed the 26,000 pound weight threshold, are suitable for limited highway use and in fact are used to a limited extent on the highway, they were nevertheless exempted from the tax because they are used primarily on rail rather than on the road.

The Congressional policy and focus which led to restructuring of the tax in question in 1982 is straightforward. Vehicles which cause extensive damage to the highways because of the combination of their heavy weight and extensive use should bear the burden of the retail excise tax imposed by Code section 4051. Those articles which do not inflict such level of damage on the highways, either because of their lighter weight or because they are used primarily in a non-highway function, should not be subject to the tax.

As part of the Tax Reform Act of 1984, Congress enacted a temporary reduction (from 12% to 6%) in the rate of tax imposed on the first retail sale of railroad piggybacks during the 1-year period beginning July 18, 1984, with direction for a study to be conducted by the Department of Transportation (in consultation with the Treasury Department)

as to the appropriate application and level of the tax on railroad piggybacks. A report on the study, with recommendations, is to be submitted to Congress by May 1, 1985. (See Appendix B for copy of the statutory provision (section 936 of the 1984 Tax Reform Act) directing this study.) This rate reduction applies to a trailer or semitrailer "designed for use principally in connection with trailer-on-flatcar ["TOFC"] service by rail," but only if the seller and purchaser are properly registered and then only if the purchaser certifies to the seller, at the time and in the manner required by Treasury Regulations, that the trailer or semitrailer "will be used principally" in TOFC service. The certificate required by the Regulation makes clear that a false certification, in addition to other sanctions, subjects the signer to criminal penalties. Thus, the required certificate provides immediately above the signature that --

> "I understand that the willful use of this certificate to evade or defeat the excise tax otherwise applicable under section 4051(a), will subject me to a fine of not more than $10,000 or imprisonment of not more than 5 years, or both, together with cost of prosecution."

(b) Designed and Actual Use of Railroad Piggybacks

In accordance with the underlying policy of the restructuring of the tax in 1982, the proper application and level of the tax to be imposed on railroad piggybacks should be determined primarily, if not exclusively, by focusing on the designed use and actual use of railroad piggybacks.

Railroad piggybacks are used to enable freight to be moved long distances by rail on flatcars rather than in boxcars. The principal users of railroad piggybacks are railroads. Use of railroad piggybacks enable railroads to move freight more efficiently by decreasing handling requirements that would otherwise be necessary in loading and unloading boxcars. Highway use of railroad piggybacks is typically limited to relatively short-distance pick up and delivery between the origination or destination point and the rail terminal. The function and use of a railroad piggyback is to transport freight for long distances by rail and for short distances between the railroad terminal and the point of local origination or destination. Railroad piggybacks spend most of their time and miles in the transportation of freight by rail and not on the Nation's highways. A random survey of Nationwide railroad piggyback highway use on the basis of hubodometer readings, conducted by the Nation's largest owner of railroad piggybacks in the fall of 1984 (after enactment of the current 6% rate reduction for piggybacks), shows an average annual highway use of less than 4,000 miles.

Because railroad piggybacks are used primarily off the highway on rail, it is necessary that railroad piggybacks contain special features and construction that would be inappropriate for a trailer intended to be used primarily on the highways. These special features are required by the

Association of American Railroads ("AAR") before railroad piggybacks can be certified as such. The special features include lift pads, a stanchion plate, extra heavy-duty locking bars, extra door thickness, extra heavy-duty construction with recessed fittings, heavy-duty side posts, heavy-duty support members, and special suspension assembly. These special features and components result in a railroad piggyback being more than 1,000 pounds heavier and over $900 more costly than an over-the-road trailer. (An ordinary over-the-road trailer is estimated to have a taxable cost of about $10,600.)*/

(c) Relevant and Irrelevant Criteria for Determining Appropriate Level of Tax on Railroad Piggybacks.

Considering the Congressional purpose in imposing the retail excise tax on the sale of heavy trucks and trailers, there should be but one primary criterion in determining the appropriate application and level of tax for railroad piggybacks. That should be the percentage of their average highway use ("Highway Use Percentage").

The Highway Use Percentage for railroad piggyback equipment could appropriately be determined under one of several possible methods, each of which would produce a fraction or percentage that should be applied to the full 12% rate of tax to find the maximum reduced rate of tax

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*/ The facts and figures contained herein were supplied by various participants in the ad hoc group of suppliers and railroad users of piggyback equipment on behalf of whom this paper is submitted.

appropriately applicable to railroad piggyback equipment. One method would state Nationwide average annual mileage of highway usage by railroad piggyback equipment as a percentage of Nationwide average annual mileage of highway usage by heavy (i.e., taxable) over-the-road trailers; a second method would state Nationwide average annual mileage of highway usage by railroad piggyback equipment as a percentage of Nationwide average annual mileage of both the highway and off-highway uses of that equipment; and so on.

Only average numbers reflecting equipment usage conditions Nationwide should be employed under any of the methods for determining reduced rate of tax to be applied Nationwide to railroad piggyback equipment. Proper methodology clearly ought not employ aberrations from annual Nationwide averages as substitutes for appropriately comprenhensive averages of aggregate usage.

Whatever method is used, evidence before the Department of Transportation shows that the Highway Use Percentage for railroad piggyback equipment is quite small, justifying a reduction in the rate for railroad piggyback equipment to a point that ranges from zero to a maximum of 3%.

As previously stated, the recent random survey referred to above shows average annual highway use of railroad piggybacks to be less than 4,000 miles. The average annual highway mileage of heavy over-the-road trailers has been

estimated to range from 32,000 miles to 68,000 miles. It is believed that the lower number (32,000 miles) may include many light over-the-road trailers that are not subject to the tax imposed by section 4051 by reason of having a gross vehicle weight below the 26,000 pound threshold. It is further believed that the average annual highway mileage for over-the-road trailers comparable in size and weight to railroad piggyback equipment is in the range of 50,000 to 68,000 miles.

Under the first method (average annual piggyback highway mileage/average annual over-the-road trailer highway mileage), the Highway Use Percentage resulting under the least favorable ratio stated above (4,000/32,000) would be 12.5%, and under the most favorable (4,000/68,000) would be 5.9%. Application of those ratios to the prevailing 12% rate of excise tax on a fully taxable sale produces a maximum appropriate reduced rate of tax for railroad piggyback sales ranging from a high of 1.5% to a low of about 7/10 of 1%.

As to the second method (average annual piggyback highway mileage/average annual piggyback total mileage), Transamerica Interway Inc. in cooperation with Trailer Train Company has prepared an estimate of average annual rail mileage of railroad piggyback equipment. Based upon data for calendar year 1984 supplied by Trailer Train Company, which owns most of the flatcars used by railroads in intermodal transportation, it is

estimated that average annual rail mileage of railroad piggyback equipment is approximately 36,000 miles. This is believed to be a conservative estimate. Based upon average annual highway mileage of railroad piggyback equipment of 4,000 miles, the Highway Use Percentage under this formulation is 10% (4,000/40,000). Application of this percentage to the prevailing 12% tax rate produces an appropriate reduced rate of tax of 1.2% for sales of railroad piggyback equipment.

A railroad locomotive, boxcar or other rolling stock is not, and obviously should not be, subject to this retail excise tax. The simple reason is that such equipment does not use the highways. The same is true as to railroad piggybacks. Railroad piggybacks generally are not used over the highways; they are used primarily off the highways in rail (and sometimes in over-the-water) service. They are more akin to boxcars or rail vans or other railroad rolling stock than to over-the-road trailers. They should either be wholly exempt from the tax or subject to the tax at a significantly lower rate.

Nevertheless, in view of some of the extraneous and irrelevant issues that have been raised in the past with respect to the appropriate application and level of the tax to railroad piggybacks, a reemphasis of the obvious is perhaps appropriate. For example, opponents of an exemption or rate reduction for railroad piggybacks have suggested that such an exemption or rate reduction constitutes a subsidy to railroad

49-704 O—85——15

piggyback users at the expense of heavy truckers. It is submitted that this is the exact opposite of what is true. If the rate of tax on railroad piggybacks were allowed to revert to 12%, or even were permitted to continue at the existing 6% rate, such rates of tax would greatly exceed the rate that would be appropriate to the Highway Use Percentage for piggybacks. With a full 12% or even a partial 6% rate on railroad piggybacks, there truly would be a "hidden subsidy" benefiting heavy highway users at the expense of railroad and other off-highway users. Obviously, if aircraft, ships, and railroad locomotives and boxcars were subjected to the retail excise tax imposed by section 4051, highway users would have to pay less tax with respect to their heavy trucks. Yet, no one would seriously suggest that the failure to impose the tax on such items represents a subsidy to the airlines, shipping companies and railroads at the expense of the highway truck users. Railroad piggybacks are used primarily as an alternative to boxcars. A railroad piggyback is primarily designed for use, and is in fact primarily used, for off-highway service -- on rail (or over water to a lesser extent) -- not for service on highways. It is therefore incongruous to assert that a rate reduction for railroad piggybacks which is consistent with their design use, and actual use, primarily off-highway on rail constitutes a subsidy to the railroads.

Another argument has been raised by opponents of an exemption or rate reduction for railroad piggybacks. That is that the effect of an exemption or rate reduction, to the extent that the tax savings would exceed the additional cost of a railroad piggyback over the cost of an over-the-road trailer, could lead to potential tax abuse, whereby an over-the-road trucker would purchase a railroad piggyback merely to avoid the tax. Existing evidence clearly indicates that the existing 6% rate reduction has not led to such abuse. Of course, in the case of a 6% rate reduction, the tax savings does not exceed the additional cost of equipping a railroad piggyback trailer to AAR specifications. Obviously, since there has never been a total exemption for railroad piggybacks, one cannot know with certainty whether a Nationwide change in the pattern of highway use by railroad piggybacks might occur in the future if there were a complete exemption for them. The better view is that an over-the-road user would not logically add 1000 pounds of weight to his truck (and in the process commit a criminal offense by falsely certifying as to non-highway use of the trailer) merely to create a savings of a few hundred dollars.

II. LEGISLATION RECOMMENDED

(a) Permanent Reduction of Rate for Railroad Piggybacks to Not More than 3% for Sales on and after July 18, 1985.

It is recommended that section 4051(d)(1) of the Internal Revenue Code be amended to make permanent the

temporary, 1-year rate reduction for railroad piggybacks (which is currently scheduled to expire as to sales after July 17, 1985). It is further recommended that the rate of tax for railroad piggybacks be set at not more than 3% for sales after July 17, 1985, until the expiration of the entire tax (which is scheduled to expire as to sales after September 30, 1988).

Railroad piggybacks are primarily designed for, and primarily used in, off-highway rail transportation. Railroad piggybacks are not used extensively in highway transportation. To the extent that railroad piggybacks do not use and damage the highways (in relation to the use and damage of highways by over-the-road trailers) railroad piggybacks should not be subject to special taxes to pay for maintenance of highways, just as over-the-road trailers should not be required to pay for maintenance of the Nation's rail system.

A strong case can be made for total exemption of railroad piggybacks from the tax imposed by Code section 4051, as is presently the case with rail vans and light trucks. Nevertheless, a complete exemption is not urged herein. Instead, it is recommended that the rate of tax be set at a level that reflects the limited percentage of highway use by railroad piggybacks.

If there really is a serious concern that the future might bring Nationwide changes in the patterns for use of transportation equipment involving a substantial increase in

the Highway Use Percentage for railroad piggyback equipment, there are mechanisms that would readily meet such fears. One such mechanism would be for the Congress to authorize the Treasury Department, on prescribed terms and conditions, to promulgate regulations making a prospective increase in the reduced rate of tax for railroad piggybacks. The prescribed terms and conditions would permit the Treasury to exercise its authority to increase the rate of tax only to the extent the rate increase was substantiated by the previously promulgated results of a periodic review required to be made every 3 years by the Department of Transportation to determine any significant increases in the Nationwide Highway Use Percentage for railroad piggybacks. Such a prospective increase in the rate of tax for railroad piggybacks should not be allowed to exceed one percentage point for each 10% increase Nationwide in the Highway Use Percentage for railroad piggybacks. Thus, if the present federal excise tax on heavy trucks and trailers were to be extended beyond its presently scheduled date of expiration as to sales of equipment made after September 30, 1988, the rate of reduced tax on railroad piggyback equipment might be increased by one percentage point in the case of equipment sold after September 30, 1989, if 90 days or more before that date the Treasury promulgated a regulation to that effect, and if before promulgation of such regulation there had been published in the Federal Register the required finding

by the Department of Transportation, made (after public notice and hearing), that the Highway Use Percentage for railroad piggyback equipment during the 3 years ending September 30, 1988, showed at least a 10% increase Nationwide over the Highway Use Percentage for such equipment in the prior 3-year period.

(b) Technical Amendments to Effectuate Intended Tax Rate Reduction Instead of Mere Defferal of Tax for Railroad Piggybacks

It is recommended that there be enacted, effective as to railroad piggyback sales on and after July 18, 1984, the technical amendments to Code section 4051(d)(3) needed to cause the Congressionally intended rate reduction for railroad piggybacks to operate as such and not merely as a tax deferral. This preferably should be accomplished by retroactively repealing the additional tax imposed by section 4051(d)(3) as a result of any railroad piggyback's change in qualifying use (whether by resale or otherwise), occuring after the first retail sale. Alternatively, this could be done by retroactively imposing on the additional tax on non-qualifying use the below described pair of limits on both the time for its application and its amount.

Paragraph (3) of Code section 4051(d) defeats the Congressionally intended rate reduction for railroad piggybacks by imposing an additional tax of 6% of the original purchase price of a railroad piggyback if it is at any time used or

resold for use other than principally in TOFC service. There is absolutely no time limitation within which such use conversion may occur for the additional tax to be triggered. Railroad piggybacks will eventually be scrapped or resold for use other than principally in TOFC service (e.g., storage, local transportation, etc.), but typically not until they have been used for many years in TOFC service. Thus, section 4051(d) as presently drafted erroneously converts what was intended to be a tax reduction into a tax deferral.

1. Repeal the provision in paragraph (3) of Code section 4051(d) imposing an additional tax on use conversion. The additional tax imposed by paragraph (3) on a change in the equipment's use after the original taxable sale is not necessary, and is, in fact, punitive when compared to other excise tax exemptions or rate reductions. Thus, the seven other categories of equipment exempted from this tax under the provisions of Code section 4053 make the availability of the exemption depend on the designed use of the equipment as of the time of the taxable sale -- without even requiring a certificate of such designed use to be executed under criminal penalties. This has the desirable effect of eliminating the problems of enforcement for the IRS and of compliance by taxpayers that result from causing a determination that must be made at the time of the sale to be changed later on by reason of facts as to actual use after the sale. The criminal and

other sanctions imposed for falsification by a purchaser of the unusual certificate required as to the intended use of a railroad piggyback should be sufficient additional protection, without adding the administrative and compliance costs and burdens associated with continuous after-sale monitoring and tax reporting on uses of equipment.

2. If the additional tax were nevertheless retained, a pair of limits on both the time for its application and its amount should be imposed to help correct the error.

(a) Imposition of time limit for application of additional tax under paragraph (3). -- There clearly should be no additional tax if a railroad piggyback is used principally in TOFC service or other non-highway use for a significant period, which could be from 6 months to 2 years. This change in the statute can be accomplished by amending the first clause of paragraph (3) of Code section 4051(d), inserting immediately after "paragraph (2)" the following: "within [insert a period not less than 6 months nor more than 2 years] of the date such trailer or semitrailer is placed in service."

(b) Limitation on amount of additional tax. -- The amount of any additional tax should be limited so that such additional tax, when considered together with the tax previously paid on the railroad piggyback, will not exceed 12% of its resale or fair market value at the time of the change to a disqualifying use. Such a change would achieve the proper

result of limiting the imposition of the full rate of tax only to the value of the equipment at the time of its conversion to the highway uses appropriately covered by the tax.

This limitation can be accomplished by amending subparagraph (B) of paragraph (3) of section 4051(d) to read as follows:

> "(B) the amount of the tax imposed under subsection (a) on such sale shall be equal to 12% of the amount for which the trailer is so resold (or in the case of a trailer which is not so resold but which is used for a use other than a use described in paragraph (2), 12% of the fair market value of the trailer determined at the time of such change in use), reduced (but not below zero) by the amount of tax previously imposed under subsection (a) with respect to such trailer."

Effective date. -- To effectuate the Congressionally intended rate reduction, the corrective technical amendment should be made effective as if included in the railroad piggyback rate reduction provision upon its original enactment, so that the provision as amended applies to any sale of a railroad piggyback made after July 17, 1984.

* * *

APPENDIX A

Subchapter B—Heavy Trucks and Trailers

Sec. 4051. Imposition of tax on heavy trucks and trailers sold at retail.
Sec. 4052. Definitions and special rules.
Sec. 4053. Exemptions.

SEC. 4051. IMPOSITION OF TAX ON HEAVY TRUCKS AND TRAILERS SOLD AT RETAIL.

(a) IMPOSITION OF TAX.—

(1) IN GENERAL.—There is hereby imposed on the first retail sale of the following articles (including in each case parts or accessories sold on or in connection therewith or with the sale thereof) a tax of 12 percent of the amount for which the article is so sold:

(A) Automobile truck chassis.

(B) Automobile truck bodies.

(C) Truck trailer and semitrailer chassis.

(D) Truck trailer and semitrailer bodies.

(E) Tractors of the kind chiefly used for highway transportation in combination with a trailer or semitrailer.

(2) EXCLUSION FOR TRUCKS WEIGHING 33,000 POUNDS OR LESS.—The tax imposed by paragraph (1) shall not apply to automobile truck chassis and automobile truck bodies, suitable for use with a vehicle which has a gross vehicle weight of 33,000 pounds or less (as determined under regulations prescribed by the Secretary).

(3) EXCLUSION FOR TRAILERS WEIGHING 26,000 POUNDS OR LESS.—The tax imposed by paragraph (1) shall not apply to truck trailer and semitrailer chassis and bodies, suitable for use with a trailer or semitrailer which has a gross vehicle weight of 26,000 pounds or less (as determined under regulations prescribed by the Secretary).

(4) SALE OF TRUCKS, ETC., TREATED AS SALE OF CHASSIS AND BODY.—For purposes of this subsection, a sale of an automobile truck or truck trailer or semitrailer shall be considered to be a sale of a chassis and of a body described in paragraph (1).

(b) SEPARATE PURCHASE OF TRUCK OR TRAILER AND PARTS AND ACCESSORIES THEREFOR.—Under regulations prescribed by the Secretary—

(1) IN GENERAL.—If—

(A) the owner, lessee, or operator of any vehicle which contains an article taxable under subsection (a) installs (or causes to be installed) any part or accessory on such vehicle, and

(B) such installation is not later than the date 6 months after the date such vehicle (as it contains such article) was first placed in service,

then there is hereby imposed on such installation a tax equal to 12 percent of the price of such part or accessory and its installation.

(2) EXCEPTIONS.—Paragraph (1) shall not apply if—

(A) the part or accessory installed is a replacement part or accessory, or

(B) the aggregate price of the parts and accessories (and their installation) described in paragraph (1) with respect to any vehicle does not exceed $200 (or such other amount or amounts as the Secretary may by regulations prescribe).

(3) INSTALLERS SECONDARILY LIABLE FOR TAX.—The owners of the trade or business installing the parts or accessories shall be secondarily liable for the tax imposed by paragraph (1).

(c) TERMINATION.—On and after October 1, 1988, the taxes imposed by this section shall not apply.

(d) TEMPORARY REDUCTION IN TAX ON CERTAIN PIGGYBACK TRAILERS—

(1) IN GENERAL.—In the case of piggyback trailers or semitrailers sold within the 1-year period beginning on the date of the enactment of the Tax Reform Act of 1984, subsection (a) shall be applied by substituting "6 percent" for "12 percent".

(2) PIGGYBACK TRAILERS OR SEMITRAILERS.—For purposes of this subsection, the term "piggyback trailers or semitrailers" means any trailer or semitrailer—

(A) which is designed for use principally in connection with trailer-on-flatcar service by rail, and

(B)(i) both the seller and the purchaser of which are registered in a manner similar to registration under section 4222, and

(ii) with respect to which the purchaser certifies (at such time and in such form and manner as the Secretary prescribes by regulations) to the seller that such trailer or semitrailer—

(I) will be used, or resold for use, principally in connection with such service, or

(II) will be incorporated into an article which will be so used or resold.

(3) ADDITIONAL TAX WHERE NONQUALIFIED USE.—If any piggyback trailer or semitrailer was subject to tax under subsection (a) at the 6 percent rate and such trailer or semitrailer is used or resold for use other than for a use described in paragraph (2)—

(A) such use or resale shall be treated as a sale to which subsection (a) applies,

(B) the amount of the tax imposed under subsection (a) on such sale shall be equal to the amount of the tax which was imposed on the first retail sale, and

(C) the person so using or reselling such trailer or semitrailer shall be liable for the tax imposed by subsection (a).

(e) TRANSITIONAL RULE.—In the case of any article taxable under subsection (a) on which tax was imposed under section 4061(a), subsection (a) shall be applied by substituting "2 percent" for "12 percent".

Source: New.

SEC. 4052. DEFINITIONS AND SPECIAL RULES.

(a) FIRST RETAIL SALE.—For purposes of this subchapter—

(1) IN GENERAL.—The term "first retail sale" means the first sale, for a purpose other than for resale, after manufacture, production, or importation.

(2) LEASES CONSIDERED AS SALES.—Rules similar to the rules of section 4217 shall apply.

(3) USE TREATED AS SALE.—

(A) IN GENERAL.—If any person uses an article taxable under section 4051 before the first retail sale of such article, then such person shall be liable for tax under section 4051 in the same manner as if such article were sold at retail by him.

(B) EXEMPTION FOR USE IN FURTHER MANUFACTURE.—Subparagraph (A) shall not apply to use of an article as material in the manufacture or production of, or as a component part of, another article to be manufactured or produced by him.

(C) COMPUTATION OF TAX.—In the case of any person made liable for tax by subparagraph (A), the tax shall be computed on the price at which similar articles are sold at retail in the ordinary course of trade, as determined by the Secretary.

(b) DETERMINATION OF PRICE.—

(1) IN GENERAL.—In determining price for purposes of this subchapter—

(A) there shall be included any charge incident to placing the article in condition ready for use,

(B) there shall be excluded—

(i) the amount of the tax imposed by this subchapter,

(ii) if stated as a separate charge, the amount of any retail sales tax imposed by any State or political subdivision thereof or the District of Columbia, whether the liability for such tax is imposed on the vendor or vendee,

(iii) the fair market value (including any tax imposed by section 4071) at retail of any tires (not including any metal rim or rim base), and

(iv) the value of any component of such article if—

(I) such component is furnished by the first user of such article, and

(II) such component has been used before such furnishing, and

(C) the price shall be determined without regard to any trade-in.

(2) SALES NOT AT ARM'S LENGTH.—In the case of any article sold (otherwise than through an arm's-length transaction) at less than the fair market price, the tax under this subchapter shall

SEC. 4053. EXEMPTIONS.

No tax shall be imposed by section 4051 on any of the following articles:

(1) CAMPER COACHES BODIES FOR SELF-PROPELLED MOBILE HOMES.—Any article designed—

(A) to be mounted or placed on automobile trucks, automobile truck chassis, or automobile chassis, and

(B) to be used primarily as living quarters or camping accommodations.

(2) FEED, SEED, AND FERTILIZER EQUIPMENT.—Any body primarily designed—

(A) to process or prepare seed, feed, or fertilizer for use on farms,

(B) to haul feed, seed, or fertilizer to and on farms,

(C) to spread feed, seed, or fertilizer on farms,

(D) to load or unload feed, seed, or fertilizer on farms, or

(E) for any combination of the foregoing.

(3) HOUSE TRAILERS.—Any house trailer.

(4) AMBULANCES, HEARSES, ETC.—Any ambulance, hearse, or combination ambulance-hearse.

(5) CONCRETE MIXERS.—Any article designed—

(A) to be placed or mounted on an automobile truck chassis or truck trailer or semitrailer chassis, and

(B) to be used to process or prepare concrete.

(6) TRASH CONTAINERS, ETC.—Any box, container, receptacle, bin or other similar article—

(A) which is designed to be used as a trash container and is not designed for the transportation of freight other than trash, and

(B) which is not designed to be permanently mounted on or permanently affixed to an automobile truck chassis or body.

(7) RAIL TRAILERS AND RAIL VANS.—Any chassis or body of a trailer or semitrailer which is designed for use both as a highway vehicle and a railroad car. For purposes of the preceding sentence, piggy-back trailer or semitrailer shall not be treated as designed for use as a railroad car.

APPENDIX B

SEC. 934. STUDY OF PIGGYBACK TRAILERS.

(a) IN GENERAL.—The Secretary of Transportation (in consultation with the Secretary of the Treasury) shall conduct a study of the appropriate application and level of the tax imposed by section 4051 of the Internal Revenue Code of 1954 (relating to tax on trucks and trailers sold at retail) on piggyback trailers and semi-trailers.

(b) REPORT.—Not later than May 1, 1985, the Secretary of Transportation shall submit to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate a report on the study conducted under subsection (a) together with such recommendations as the Secretary may deem advisable.

APPENDIX C

SEC. 933. WEIGHT-DISTANCE TAXES.

The Secretary of Transportation shall conduct a study to evaluate the feasibility and ability of weight-distance truck taxes to provide the greatest degree of equity among highway users, to reduce the costs of compliance of such taxes, and to improve the efficiency by which such taxes might be administered. Such study shall also include an evaluation of the evasion potential for weight-distance taxes and an assessment of the benefits to interstate commerce of replacing all Federal truck taxes (other than fuel taxes) with a weight-distance tax.

APPENDIX D

SEC. 934. REPORTS, ETC.

(a) CONSULTATION WITH TREASURY.—Studies conducted under this part shall be conducted in consultation with the Secretary of the Treasury.

(b) REPORT.—Not later than October 1, 1987, the Secretary of Transportation shall submit to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate a report on each study conducted under this part together with such recommendations as the Secretary may deem advisable.

Mr. PICKLE. Mr. Wickham, did you want to make any statement?

Mr. WICKHAM. No separate statement, Mr. Pickle. Thank you. I would be happy to assist in answering any questions.

Mr. PICKLE. Are you asking for an extension of the time limit, or are you objecting to the fact there is no time limit involved?

Mr. KENNY. I am sorry, Mr. Chairman, I am not quite sure I understand your question.

Mr. PICKLE. You said here that there is no time limit on which the use conversion must occur to trigger additional tax.

Mr. KENNY. Yes.

Mr. PICKLE. Do you want a time specific, or just repeal?

Mr. KENNY. Our initial position is that consistent with the exemption accorded to other types of equipment, it should simply be repealed so there would be no tax imposed on a resale. As an alternative to that, if it is deemed there should be some tax imposed, we would suggest there would be a time limit on if the sale occurred after an agreed-upon date.

Mr. PICKLE. We have this under study now. If we did put a time limit, what length of time would you recommend? I know what you prefer.

Mr. KENNY. My view on that is that what you are trying to protect here is a purchase and then a quick resale in order to avoid the tax. If that is going to occur, it will occur in a relatively short period of time. Other than that, it would be a bona fide sale. I would say a year or so would be an appropriate time after which tax would not be imposed on the resale.

Mr. PICKLE. Are you in general agreement with that?

Mr. WICKHAM. Yes, sir, I think that I agree completely with what Mr. Kenny said.

Mr. PICKLE. I don't know what the committee would do, repeal or the other.

Mr. WICKHAM. I might just add, on the point about repeal, the statute has unusual requirements already in the case of the piggyback rate reduction to protect against efforts to take improper advantage of that. It has this certificate requirement in the statute, the purchaser must execute a certificate—under penalty of criminal perjury—that he intends to use this equipment in trailer-on-flatcar service by rail, and that requirement has been the subject of enforcement activity by IRS in past years and is taken seriously.

Also, the equipment has to be specially designed to qualify for the rate reduction. There has been a booklet submitted by Mr. Kenny which shows the kind of special design requirements that have to be met even to be eligible for this rate reduction, and there are several different protections that the statute has built in that I personally think make it unnecessary to go into this business of an additional tax.

Mr. PICKLE. Are we talking about any revenue at all on this if we did repeal the additional tax on use conversion?

Mr. KENNY. I would think, Mr. Chairman, that the amount of money that we are talking about here is really modest, particularly in light of the efforts that would be needed to collect it. You are only talking at the present time about those piggyback trailers that were sold during a 1-year period that the reduction is in effect. That number is relatively small from the numbers.

Mr. PICKLE. Did you have an additional statement?

Mr. KENNY. I don't have a figure. I think it is a negligible amount of——

Mr. PICKLE. Well, try to ascertain that.

Mr. KENNY. We would certainly make a submission on that.

[The information follows:]

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DALE W. WICKHAM

July 29, 1985

Mr. Joseph K. Dowley
Chief Counsel
Committee on Ways & Means
U. S. House of Representatives
Washington, D. C.

Dear Mr. Dowley:

Enclosed are revenue estimates prepared by Dr. Gerard M. Brannon of the effect of legislation that would extend with technical changes for the rest of the life of federal retail excise tax on heavy trucks the rate reduction provided under Code section 4051(d) for railroad piggyback trailers in recognition of the limited highway use of such equipment.

Dr. Brannon's revenue estimates show that enactment later this year of legislation extending this excise tax rate reduction at a 3% level for railroad piggyback equipment from July 18 of this year forward until the scheduled termination of this excise tax on September 30, 1988, would lose revenue of $11.7 million for fiscal 1986, $12.2 million for 1987, and $13.1 million for 1988. Limiting the rate of such tax to a maximum of 3% in the case of railroad piggyback equipment is strongly supported by detailed new industry studies of the percentage of highway use of that equipment (see page 5 and pages 5-7 of Attachment B to the written statement of Mr. Dennis J. Kenny, chairman of an ad hoc group of railroad piggyback equipment suppliers and users, submitted May 16, 1985, at hearings before the Committee on H.R. 1800). These confirm earlier evidence that the percentage of highway use by piggyback equipment meeting the requirements for certification as such by the Association of American Railroads is so limited that this railroad equipment properly should be subject to tax at a rate of not more than 1.5%, if not entirely exempted from the tax.

Dr. Brannon's revenue estimates also show that there would be a negligible or zero revenue effect for each relevant fiscal year for a proposed technical amendment that would prevent any additional tax on a later conversion to highway use from applying to railroad piggyback equipment sales made after July 17 of last

year. This confirms the testimony of Mr. Kenny in response to a question from Mr. Pickle at the hearing of the Committee noted above. Since this supplies the additional information requested by Mr. Pickle on this point, it is requested that this letter and the enclosed materials from Dr. Brannon be incorporated in the record of the transcript of that hearing immediately following Mr. Kenny's testimony.

Very sincerely yours,

Dale W. Wickham
Counsel to the ad hoc group

DWW:elj
Enclosure

Gerard M. Brannon
3800 Fairfax Drive, Apt. 1802
Arlington, Virginia 22203
527-5735

July 22, 1985

Dale W. Wickham
Piper & Marbury
888 - 16th Street, N.W.
Fifth Floor
Washington, D.C. 20006

RE: Revenue estimates for legislation to extend, with technical changes, an excise tax rate reduction for railroad piggyback trailers

Dear Dale:

In response to your request, the following sets forth my estimates of the revenue impact, prepared on a cash receipts basis for fiscal years 1985 through 1990, of proposed legislation that would extend through the life of the tax, with technical changes, an excise tax rate reduction on the first retail sale of railroad piggyback trailers. My assumptions are set forth in the attached memorandum.

Assuming a reduction to 6% in the rate of tax, the revenue loss is estimated as follows:

Fiscal Year	1985	1986	1987	1988	1989	1990
Revenue Loss (Gain) [$ Millions]	0	7.8	8.1	8.7	0.3	0

Assuming a reduction to 3% in the rate of tax, the revenue loss is estimated as follows:

Fiscal Year	1985	1986	1987	1988	1989	1990
Revenue Loss (Gain)	0	11.7	12.2	13.1	0.5	0

For each percentage point the rate is reduced below 12 percent, the revenue loss (gain) would be as follows:

Fiscal Year	1985	1986	1987	1988	1989	1990
Revenue Loss (Gain)	0	1.3	1.4	1.5	0.1	0

The revenue effect of the technical amendment to Code section 4051(d)(3) would be zero or negligible for each of the fiscal years 1985 through 1990.

Sincerely,

Gerard M. Brannon

GMB:ssm

MEMORANDUM

TO: Dale W. Wickham

FROM: Gerard M. Brannon

DATE: July 22, 1985

RE: Assumptions relating to revenue estimates for legislation to extend, with technical changes, an excise tax rate reduction for railroad piggyback trailers

The revenue estimates set forth in my letter to you dated July 22, 1985 are based on the following assumptions:

1. Legislation will be enacted between September 15, 1985 and December 31, 1985;

2. The legislation continuing a rate reduction will be effective July 18, 1985;

3. The tax imposed by section 4051 will expire for sales after September 30, 1988, as presently provided in Code section 4051(c);

4. Taxpayers will make semi-monthly deposits of the required tax on the 24th day of the month for sales made during the first 15 days of such month, and on the 9th day of the month for sales made during the last half of the preceding month;

5. Section 4051(d)(3) of the Code will either be repealed or amended so that no additional tax would be imposed unless a use conversion occurs within one year of the date the piggyback equipment is placed in service, which amendment would be applicable to any sale of railroad piggyback equipment made after July 17, 1984; and there will be few, if any, instances where railroad piggyback equipment acquired after July 17, 1984 will be converted before October 1, 1988 to a use other than principally in connection with trailer-on-flatcar service by rail;

6. Sales of piggyback trailers will average 10,700 over the next 6 years with the price rising from $12,300 in 1985 to 15,000 in 1990. These assumptions are explained in the attached memorandum from Transamerica Interway Inc. This memorandum reflects prior exchanges between James Davies of Transamerica Interway and myself, and I regard it as a reasonable estimate.

Additional information is contained in the attachments hereto.

Gerard M. Brannon

Revenue Estimates For Extension of Excise Tax Rate Reduction
For Railroad Piggybacks For 5-Year Budget Period - Attachments

I. Revenue effect of continuation of a rate reduction beyond July 17, 1985.

A. Calendar year liability basis.

Calendar Year	Railroad Piggyback Trailers Acquired[a/]	Average Taxable Price[a/]	Revenue Loss ($ Millions) Reduction to 6% rate of tax	Reduction to 3% rate of tax
1985 (7/18-12/31)	3,300	$12,300	2.4	3.7
1986	9,800	$12,800	7.5	11.3
1987	10,500	$13,300	8.4	12.6
1988	8,100[aa/]	$13,700[aa/]	6.7	10.0
1989	(Tax imposed by section 4051 expires as to sales after September 30, 1988.)		-0-	-0-
1990			-0-	-0-

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a/ Derived from industry sources.

aa/ Assumes projected new piggyback purchasers of 10,800 units for calendar year 1988 will be purchased pro rata throughout the calendar year so that 8,100 will be purchased through September 30, 1988. A pro rata increase in average price is likewise assumed.

B. Fiscal year liability basis.

Fiscal Year (9/30)	Railroad Piggyback Trailers Acquired	Average Taxable Price	Revenue Loss ($ Millions) Reduction to 6% rate of tax	Reduction to 3% rate of tax
1985 (7/18-9/30)	1,500	$12,300	1.1	1.7
1986	1,800	$12,300	7.0	10.5
	7,350	$12,800		
1987	2,450	$12,800	8.2	12.3
	7,875	$13,300		
1988	2,625	$13,300	8.8	13.1
	8,100	$13,700		
1989	-0-	-0-	-0-	-0-
1990	-0-	-0-	-0-	-0-

C. Fiscal year cash receipts basis (assuming legislation is enacted after 9/15/85 and before 12/31/85; without adjustment for two-week collection lag).

Fiscal Year (9/30)	Revenue Loss ($ Millions) Reduction to 6% rate of tax	Reduction to 3% rate of tax
1985	-0-	-0-
1986	8.1	12.1
1987	8.2	12.3
1988	8.8	13.1
1989	-0-	-0-
1990	-0-	-0-

D. Cash receipts basis (same assumptions as C above, with adjustment for two-week lag in tax payments).

Fiscal Year	Revenue Loss ($ Millions) Reduction to 6% rate of tax	Reduction to 3% rate of tax
1985	-0-	-0-
1986	7.8	11.7
1987	8.1	12.2
1988	8.7	13.1
1989	0.3	0.5
1990	-0-	-0-

II. Technical correction to repeal or modify "recapture" provision of section 4051(d).

The revenue effect of repeal or modification of the "recapture" provision of Code section 4051(d)(3) will be "zero" or negligible because all or substantially all of the railroad piggyback equipment acquired on or after July 18, 1984 will be used principally in connection with trailer-on-flatcar service by rail beyond the date of scheduled expiration of the tax, October 1, 1988.

PROJECTED RAILROAD PIGGYBACK EXCISE TAX

7/17/85 - 9/30/90

Transamerica Interway estimates that, over the next 5.2 years, a total of 64,300 railroad piggybacks will be acquired in the United States at a cost of approximately $893 million. At a 12% excise tax rate, the loss in revenue to the Treasury of exempting railroad piggybacks from excise tax will be approximately $107 million or $21 million per year.

This figure is derived from the calculation below and in the Exhibits which follow:

		See Exhibit
Estimated industry railroad piggyback fleet as of 7/17/85	151,600	(1)
For the period end of 1984 - end of 1990 the projected		
- Ave. growth of GNP	2.9%	
- Ave. growth of Industrial Production - All Mfg.	4.7%	(2)
- Ave. growth in Piggyback Loading	4.5%	
However, the projected ave. annual railroad piggyback fleet growth	1.5%	
Reasons that fleet growth will not parallel growth in loadings are:		
- Increased use of international containers for loadings (from 26.5% in '84 to an expected 32.0% by the end of 1980). Effect - approximately 1.4% negative fleet growth.		
- Increased car miles/day from 224 in 1984 to 255 by 1990. Effect - approximately 1.0% negative fleet growth.		(3)
- Increased ave. fleet capacity due to larger (45' and 48') vans. Effect - approximately 0.6% negative fleet growth.		
Projected industry railroad piggyback fleet as of 9/30/90	167,600	
Required additions (168,500 - 151,600) =	16,000	
Projected annual replacement rate (with 50% greater during 1985)	5.8%	(4)
Projected replacement units	48,300	
Total additions plus replacements	64,300	

		See Exhibit
Net trailer prices-FOB plant, excluding tires and excise tax reflecting 4% annual inflation	$12,300 in 1985 to $15,000 in 1990	
Total cost of new railroad piggybacks	$893 million	(4)
Excise tax rate	12%	
Total excise tax 7/17/85 - 9/30/90	$107 million	
Average annual excise tax	$ 21 million	

Note: The above tax revenues may be somewhat overstated if the domestic container system develops and captures a significant proportion of piggyback loadings. However, the impact during the next 4-6 years should remain relatively small.

INDUSTRY RAILROAD PIGGYBACK FLEET-YEAR END 1984

COMPANY NAME	40' L	45' L X 96" W	45' L X 102" W	48' L	REEFERS	OTHER	TOTAL
RAILROADS							
ATCHISON, TOPEKA & SANTA FE	3,354	3,557	1,069	-	-	1,717	9,697
BURLINGTON NORTHERN	3,119	296	1,453	-	-	-	4,868
CHESSIE SYSTEM (C&O, B&O, SEABOARD)	5,709	4,102	4,902	-	1,000	807	16,520
CHICAGO & NORTH WESTERN	1,079	194	298	-	-	-	1,571
CHICAGO, MILW., ST. PAUL & PACIFIC	502	1,849	993	-	-	103	3,447
CONRAIL	2,884	1,990	650	-	-	-	5,524
GRAND TRUNK WESTERN	1,074	6	-	-	-	1	1,081
ILLINOIS CENTRAL GULF	1,410	892	98	-	-	-	2,400
NORFOLK & WESTERN	1,005	1,245	-	-	-	10	2,260
SOUTHERN PACIFIC	1,909	625	2,794	-	-	114	5,442
SOUTHERN RAILWAY	3,853	2,068	-	200	-	648	6,769
UNION PACIFIC (MISS. PAC.)	1,471	1,644	-	-	501	149	3,765
OTHER RAILROADS	5,624	6,882	791	60	24	470	13,851
SUB-TOTAL RAILROADS	32,993	25,350	13,048	260	1,525	4,019	77,195
LEASING COMPANIES (FREE RUNNERS ONLY)							
TTS	9,780	9,621	6,159	-	-	1,276	26,926
XTRA	8,882	7,031	1,514	-	-	3,060	20,487
AVAILCO	888	8,589	1,000	-	-	-	10,477
STRICK	-	1,247	-	-	-	300	1,547
VERMONT	836	500	300	-	-	-	1,636
SUB-TOTAL LEASING COMPANIES	20,476	26,988	8,973	-	-	4,636	61,073
WATER CARRIERS	3,897	637	35	-	2,721	1,594	8,884
REEFER OPERATORS	-	-	-	-	7,996		7,998
GRAND TOTAL - FLEET	57,366	52,975	22,056	260	12,232	10,249	155,138

1. BASED ON "THE OFFICIAL INTERMODAL EQUIPMENT REGISTER" DATED MARCH 1985.

2. FOR THE PERIOD 1/1/85 - 7/17/85 7,300 DISPOSALS AND ONLY 3,800 REPLACEMENTS ARE PROJECTED. THUS, THE FLEET SIZE ON 7/17/85 WILL BE 151,600. SEE EXHIBIT 3.

EXHIBIT 1.

EXHIBIT 2

ACTUAL AND PROJECTED GROWTH OF PIGGYBACK LOADINGS

Projected piggyback loadings through 1990 were determined as a function of expected Industrial Production-All Manufacturing (manufacturing index) which, in turn, is a function of GNP as shown below:

1. CURRENT CONSENSUS SUPPORTSA 2.9% AVERAGE ANNUAL GNP GROWTH RATE

   Percent increases used for the period end-1984 through end-1990 were:

Year	% Increase
1984)	
)	3.7
1985)	
)	2.0
1986)	
)	3.0
1987)	
)	3.0
1988)	
)	3.0
1989)	
)	3.0
1990)	

2. HISTORICALLY 1% INCREASE IN REAL GNP LEADS TO 1.6% INCREASE IN MANUFACTURING INDEX DURING UPTURNS

   Exhibit 2-A depicts correlation of GNP index and manufacturing index for the actual period 1972-1984 and the projections for 1985-1990.

3. FROM 1971 THROUGH 1981 PIGGYBACK LOADINGS GREW AT AN AVERAGE RATE OF 3.6% AND WAS CLOSELY CORRELATED WITH MANUFACTURING ACTIVITY

   Exhibit 2-B shows the relationship between manufacturing index and index of piggyback loadings. Through 1981 a 1% change in manufacturing led to an average 1.47% change in piggyback loadings.

4. DURING THE PERIOD 1982-1985 THE TREND LINE WAS DISPLACED

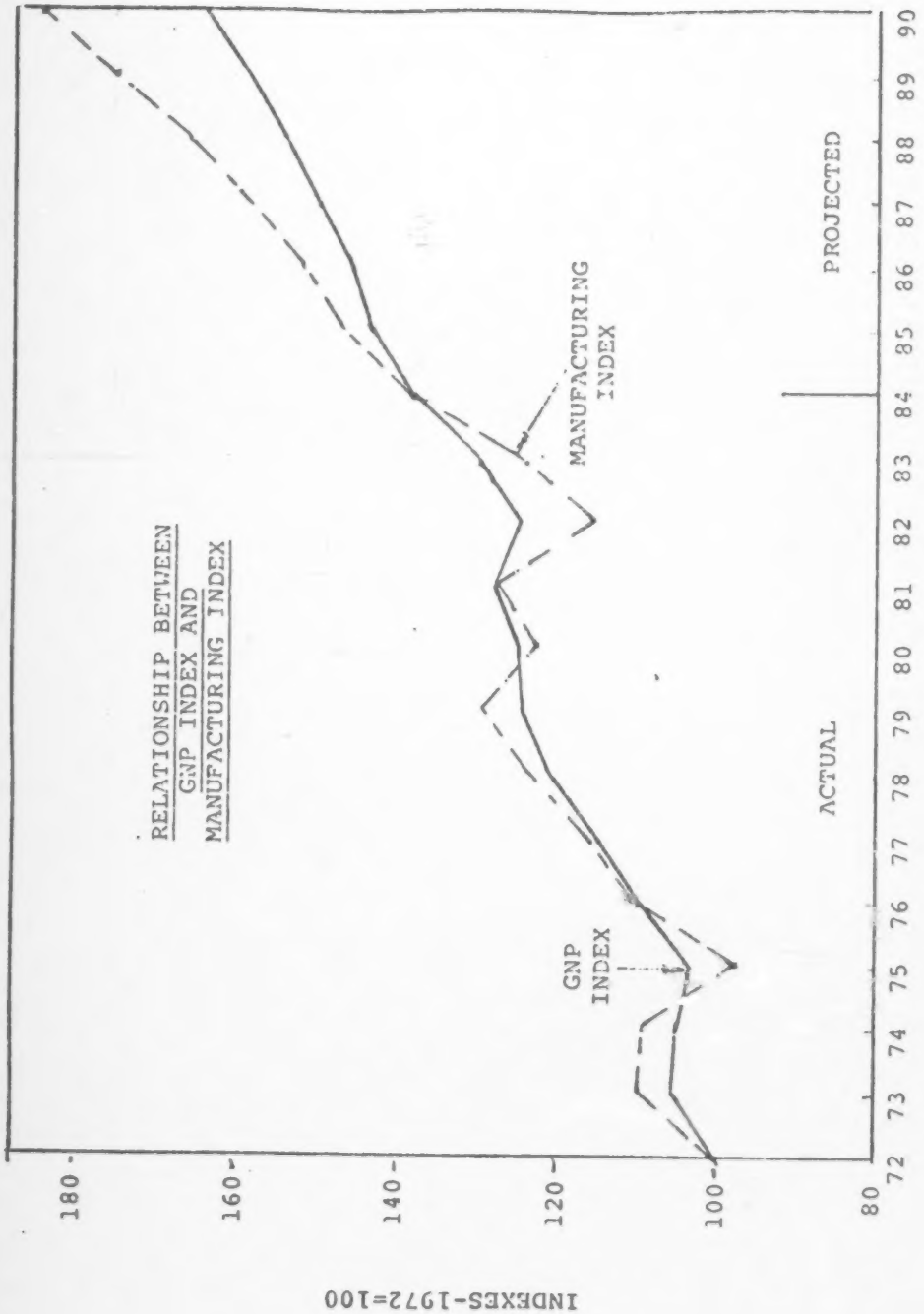
   This displacement was a result of a combination of factors:

   - Deregulation.
   - Introduction of competitive 45' railroad piggybacks.
   - And probably statistical phenomena due to double counting of separate bills of lading. An adjustment of 10% is shown on the graph to correct for double counting.

5. FROM 1984-1990 PIGGYBACK LOADINGS ARE PROJECTED TO GROW AT AN AVERAGE RATE OF 4.5% PER YEAR

   After the displacement period 1982-1985 further loadings projections were again based on the correlation experienced during the 1971-1981 period.

EXHIBIT 2-A


RELATIONSHIP BETWEEN
GNP INDEX AND
MANUFACTURING INDEX
INDEXES-1972=100
180
160
140
120
100
80
72 73 74 75 76 77 78 79 80 81 82 83 84 85 86 87 88 89 90
GNP INDEX
MANUFACTURING INDEX
ACTUAL
PROJECTED

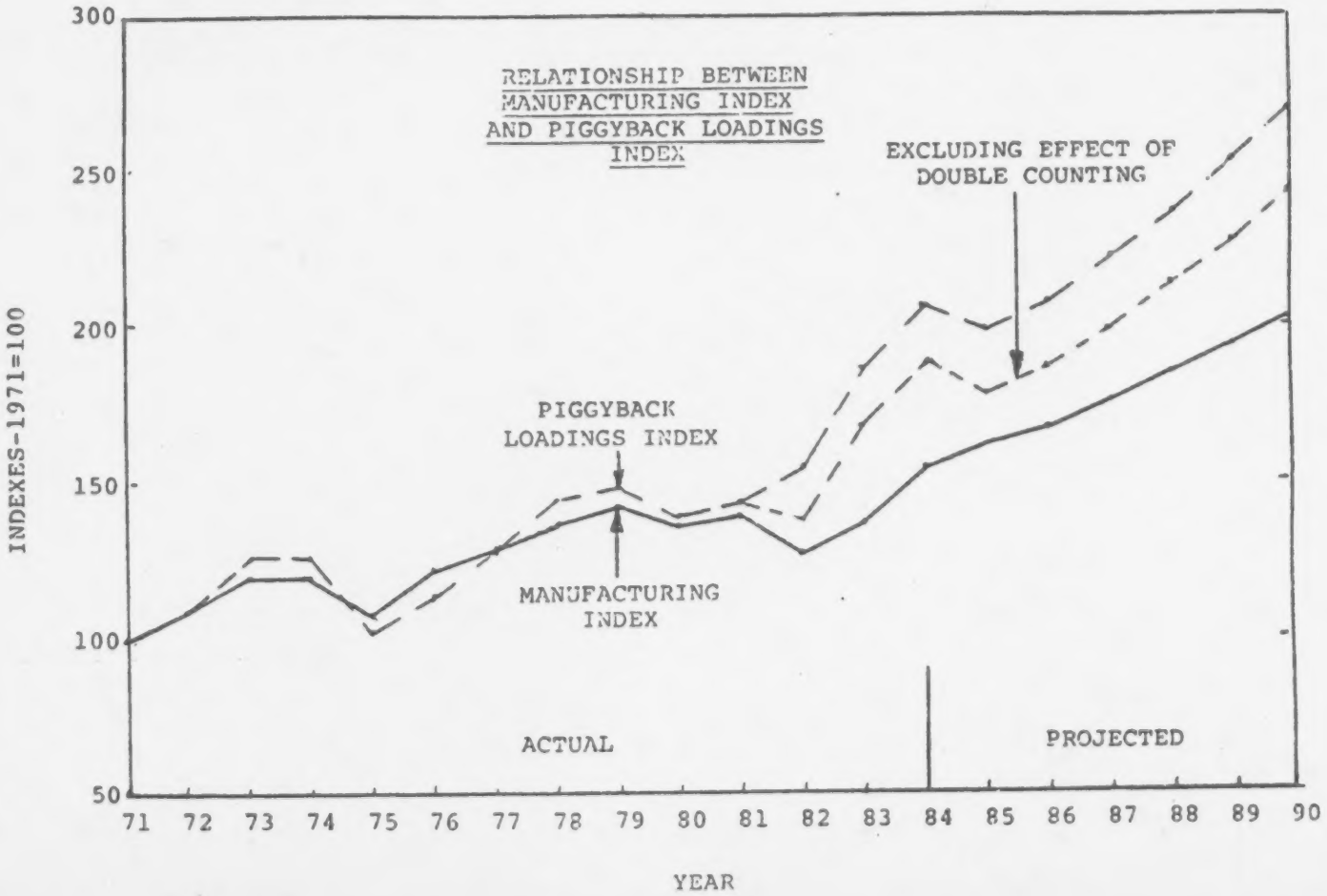

RELATIONSHIP BETWEEN
MANUFACTURING INDEX
AND PIGGYBACK LOADINGS
INDEX
EXCLUDING EFFECT OF
DOUBLE COUNTING
PIGGYBACK
LOADINGS INDEX
MANUFACTURING
INDEX
ACTUAL
PROJECTED
INDEXES-1971=100
300
250
200
150
100
50
71 72 73 74 75 76 77 78 79 80 81 82 83 84 85 86 87 88 89 90
YEAR

EXHIBIT 2-B

EXHIBIT 3

ACTUAL AND PROJECTED
RAILROAD PIGGYBACK FLEET

PROJECTED RAILROAD PIGGYBACK FLEET WILL BE DEPENDENT ON A NUMBER OF FACTORS

- Growth of containers carried on rail

There has been a steady increase in containers carried on rail.

A Trailer Train study in 1981 indicated 22.5% of hitch positions carried containers. Given 10.7% empty hitches, this equated to 25% of total loadings in containers.

A recent (1st Quarter 1984) survey of major railroads (ITA statistics) revealed an increase to 26.5%. See Exhibit 3-A.

It is anticipated that this trend will continue at a slightly increased rate through 1987 due to the impact of double stack cars in supporting landbridge growth. This trend will then tend to level off to 32% level by 1990.

- Increased car miles per day

Recent mergers, concentration into hub centers, dedicated intermodal trains, etc. have steadily increased car miles per day. Exhibit 3-B shows actual and projected rates. Exhibit 3-C shows improvement, one-half of which would be reflected in improved trailer efficiency (that portion of the time the trailer is on rail).

- Increased capacity

Exhibit 3-D compares current van size mix with that expected by 1990. During the period most new purchases will be 45' and 48' long by 102" wide while older 40' x 96" vans will be phased out. The effect will be felt as 0.6% average annual improvement in efficiency.

- Fleet utilization

The industry has experienced a sharp drop in utilization during the first half of 1985 due to simultaneous drop in intermodal loadings and increase in railroad piggyback purchases. The major area of utilization drop is in the 40' trailer fleet which was being gradually displaced by the newer, greater capacity 45' and a few 48' units. Some of the larger fleet owners (including TTS) expect to reduce their 40' inventory through an expanded disposal program during 1985.

After the 1985 low, utilization will gradually return to the normal 85% by 1989.

Exhibit 3-E displays the combined effects of utilization changes and efficiency improvements.

Exhibit 3-F shows actual and projected fleet for the period 1981 through 1990.

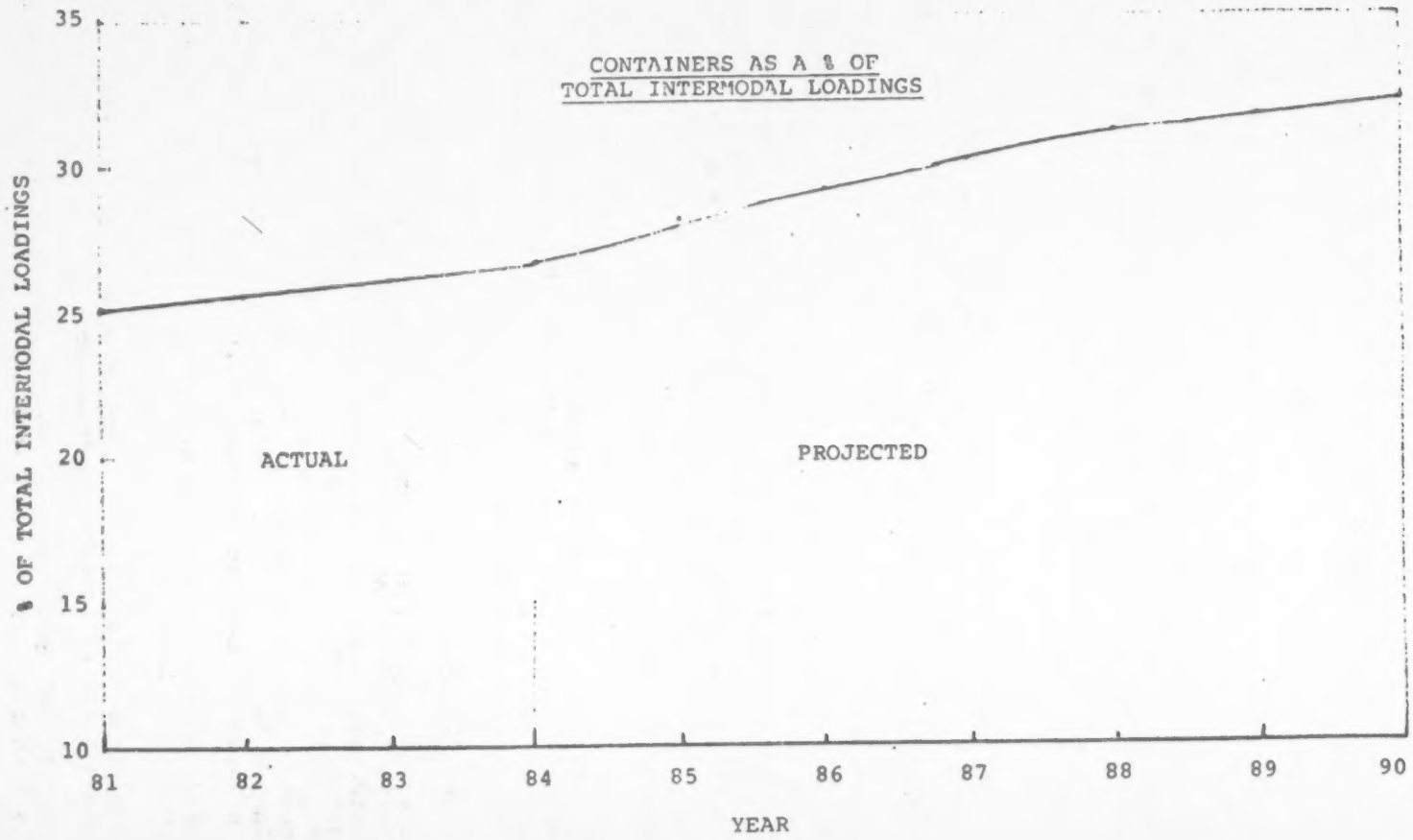

CONTAINERS AS A % OF
TOTAL INTERMODAL LOADINGS
% OF TOTAL INTERMODAL LOADINGS
35
30
25
20
15
10
ACTUAL
PROJECTED
81
82
83
84
85
86
87
88
89
90
YEAR

EXHIBIT 3-A

EXHIBIT 3-B

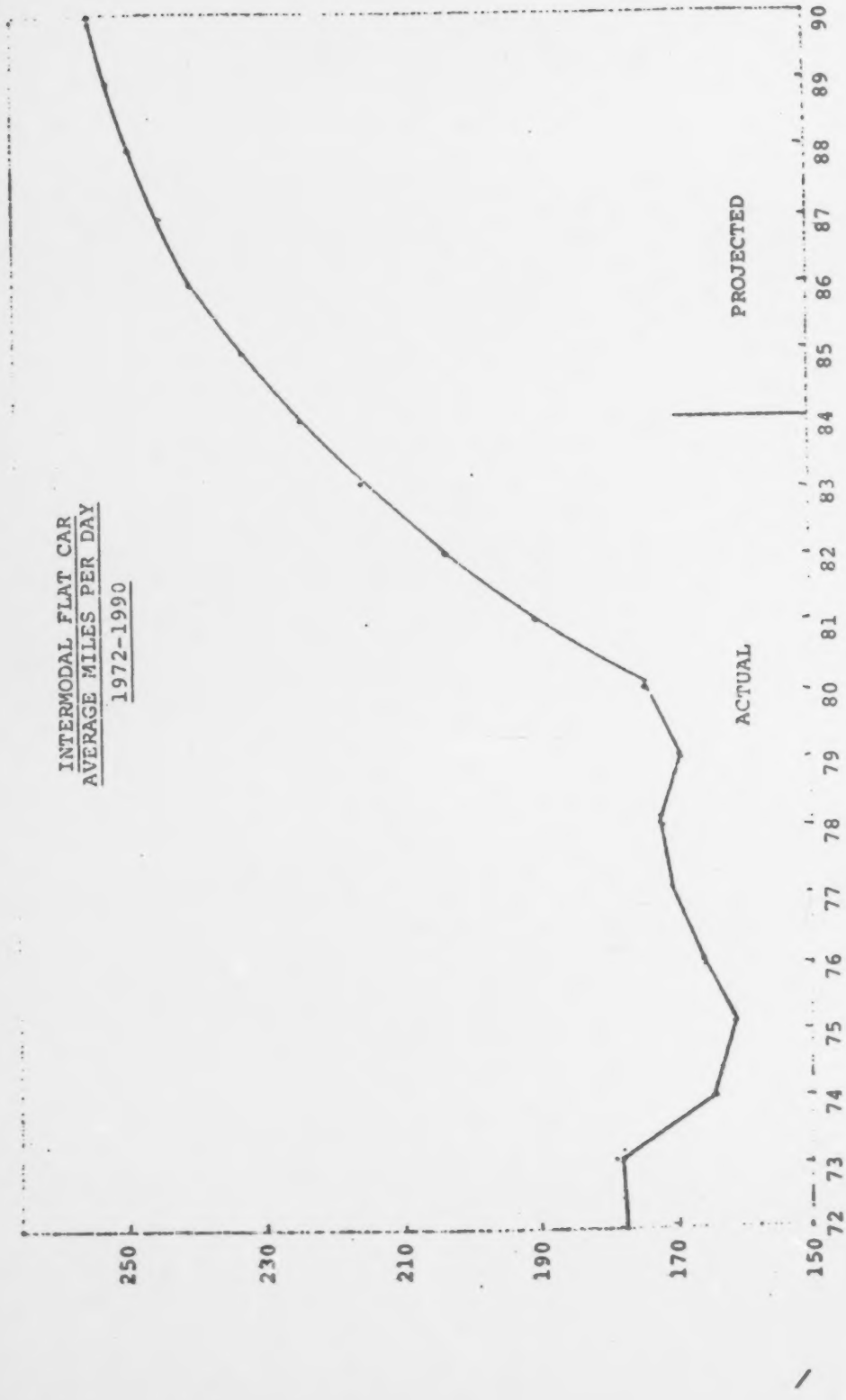

INTERMODAL FLAT CAR
AVERAGE MILES PER DAY
1972-1990
250
230
210
190
170
150
72 73 74 75 76 77 78 79 80 81 82 83 84 85 86 87 88 89 90
ACTUAL
PROJECTED

EXHIBIT 3-C

INTERMODAL FLAT CARS

EFFICIENCY IMPROVEMENT 1984-1990

BASED ON INCREASED MILES/DAY

	YEAR	AVERAGE MILES PER DAY (1)	EFFICIENCY IMPROVEMENT OF RAIL CARS	EQUIV. % EFFICIENCY OF RAILROAD PIGGYBACKS (50% OF THE TIME ON RAIL)
ACTUAL	1972	177.0		
	1973	178.0		
	1974	165.1		
	1975	161.4		
	1976	166.6		
	1977	171.5		
	1978	172.3		
	1979	169.2		
	1980	174.0		
	1981	190.0		
	1982	203.0	6.8	3.4
	1983	215.0	5.9	3.0
PROJECTED	1984	224.0	4.0	2.0
	1985	233.0	4.0	2.0
	1986	240.0	3.0	1.5
	1987	244.0	2.0	1.0
	1988	249.0	2.0	1.0
	1989	252.0	1.0	0.5
	1990	255	1.0	0.5

(1) Source - Trailer Train Statistics
1972 - 1983 - Actual
1984 - 1990 - Estimated

EXHIBIT 3-D

CAPACITY ADJUSTMENT FOR
LARGER RAILROAD PIGGYBACKS

1. RAILROAD PIGGYBACK FLEET MAKE-UP END 1984

	# UNITS	%	CU FT CAP
40'	57366	37.0	2779
45' X 96"	52975	34.1	3131
45' X 102"	22056	14.2	3331
48' X 102"	260	0.2	3556
OTHER	22481	14.5	3000
TOTAL/AVE.	155138	100.0	3011

2. ESTIMATED FLEET MAKE-UP BY 9/30/90

40'	20000	11.8	2779
45' X 96"	33300	19.6	3131
45' X 102"	44100	25.9	3331
48' X 102"	28500	16.8	3000
TOTAL/AVE.	170000	100.0	3230

3. INCREASE IN AVE. CAPACITY

= 3230 ÷ 3011 = 7.3% INCREASE OR AVE. 1.2% PER YR.

ASSUME ONLY 50% OF THE INCREASED CAPACITY WOULD DISPLACE NEW UNITS. THUS EQUIVALENT ANNUAL EFFICIENCY IMPROVEMENT WOULD BE 0.6%.

49-704 O—85——16

EXHIBIT 3-E

EFFICIENCY IMPROVEMENTS IN RAILROAD PIGGYBACK OPERATIONS

YEAR	ESTIMATED FLEET % UTILIZATION	% EFFECT ON FLEET EFFICIENCY			
		UTILIZATION	MILES/DAY	INCREASED CAPACITY	TOTAL
1984	85.1	- 8.4	+ 2.0	+ 0.6	- 5.8
1985	78.0	+ 2.6	+ 1.5	+ 0.6	+ 4.7
1986	80.0	+ 2.5	+ 1.0	+ 0.6	+ 4.1
1987	82.0	+ 2.4	+ 1.0	+ 0.6	+ 4.0
1988	84.0	+ 1.2	+ 0.5	+ 0.6	+ 2.3
1989	85.0	0	+ 0.5	+ 0.6	+ 1.1
1990	85.0				

ACTUAL AND PROJECTED RAILROAD PIGGYBACK FLEET 1981-1990

	YEAR	TOTAL INTERMODAL LOADINGS 1000 (EXCL. DOUBLE COUNTING)	% CONTAINERS HANDLED	NUMBER CONTAINERS HANDLED 1000	NUMBER TRAILER LOADS 1000	AVE. TRAILER LOADS/ TRAILER	% EFFICIENCY EFFECT	ACTUAL & PROJECTED MID-YEAR FLEET SIZE	YEAR END FLEET
ACTUAL	1981	3145.7	25.0	786.4	2359.3	16.1		146,100	145,300
	1982	3057.3	25.5	779.6	2277.7	15.6		146,000	146,700
	1983	3681.1	26.0	957.1	2724.0	18.5		147,500	148,300
	1984	4109.4	26.5	1089.0	3020.4	19.9		151,700	155,100
PROJECTED	1985	3945.6	28.0	1104.8	2840.8	18.7	- 5.8	151,900	148,700
	1986	4122.7	29.0	1195.6	2927.1	19.6	+ 4.7	149,300	149,900
	1987	4398.2	30.0	1319.5	3078.7	20.4	+ 4.1	150,900	151,700
	1988	4693.7	31.0	1455.0	3238.7	21.2	+ 4.0	152,800	153,700
	1989	5008.6	31.5	1577.7	3430.9	21.7	+ 2.3	158,100	162,500
	1990	5343.5	32.0	1709.9	3633.6	21.9	+ 1.1	165,900	169,300

FLEET GROWTH FROM END 1984 - END 1980 = $\frac{169,300}{155,100}$ = 9.2%

AVE. ANNUAL GROWTH RATE FOR THE PERIOD = 1.5%

EXHIBIT J-F

EXHIBIT 4-A

PROJECTED REPLACEMENT RATE

- TTS Experience

Year End	TTS Railroad Piggyback Fleet	Total Year Purchases	Disposals	% of Prior Year's Fleet
1980	37,760			
1981	36,670	1,880	(2,970)	7.9
1982	36,610	1,300	(1,360)	3.7
1983	36,350	3,550	(3,810)	10.4
1984	40,250	5,470	(1,570)	4.3
			Ave.	6.6%

- TTS disposal program (6.6%) is probably similar to that of Xtra, Vermont and Strick leasing companies as well as water carriers due to the rugged and varied service demands and overall fleet age mix. Reefer operators and Availco have newer fleets and railroads generally practice a longer replacement cycle so that their disposal rate is somewhat less - probably no more than 5%.

- Therefore, the industry average is probably as follows:

Owned Fleets		# Units	
TTS	(incl. long term leased units)	40,000	
Xtra	(" " " " ")	31,000	
Vermont, Strick	(" " " " ")	3,000	
Water Carriers	(excl. leased units)	5,000	
	Sub-total	79,000	51%
Railroads	(excl. long term leased units)	56,700	
Reefer Operators		8,900	
Availco		10,500	
	Sub-total	76,100	49%
	Grand Total	155,100	

Industry average = .51 x 6.6% + .49 x 5.0% = 5.8%

- During 1985 in the face of declining piggyback loadings and the increasing obsolescence trend of 40' vans, TTS has expanded their disposal program to 10% of their fleet. It is expected that other owners will do likewise so that the disposal rate for 1985 is projected to be 8.7%.

REQUIRED NEW RAILROAD PIGGYBACKS AND EXCISE TAX DURING PERIOD 7/17/85 - 9/30/90

YEAR END OR ON DATE	RAILROAD PIGGYBACK FLEET	PERIOD	DISPOSALS AT 8.7% IN 1985 AND 5.8% THEREAFTER	ADDITIONS	TOTAL NEW PIGGYBACKS	AVE. NET PIGGYBACK PRICE*	TOTAL NET COST $ MILLIONS
1984	155,100						
7/17/85	151,600	7/17-END 1985	6,200	(2,900)	3,300	$12,300	$ 41
1985	148,700						
1986	149,900	1986	8,600	1,200	9,800	$12,800	$125
1987	151,700	1987	8,700	1,800	10,500	$13,300	$140
1988	153,700	1988	8,800	2,000	10,800	$13,800	$149
1989	162,500	1989	8,900	8,800	17,700	$14,400	$255
9/30/90	167,600	1/1-9/30/90	7,100	5,100	12,200	$15,000	$183
1990	169,300						
TOTAL FOR PERIOD			48,300	16,000	64,300		$893

12% EXCISE TAX
= $107 MILLION OVER
5.2 YEARS OR
$21 MILLION/YR

* TYPICAL PRICE OF RAILROAD PIGGYBACK FOB PLANT WITHOUT TIRES AND NET OF EXCISE TAX - 4% ANNUAL INFLATION.

EXHIBIT 4B

Mr. PICKLE. I think your request seems to be reasonable, and we are glad to have your testimony. I know you submitted also a booklet showing the type of trailers and vehicles that are involved. I know that will be helpful to the committee, it will to me, because I am trying to understand it. I appreciate this information and your statement. Do you have any statement, Mr. Heffernan?

Mr. HEFFERNAN. No; I simply concur with what Mr. Kenny said.

Mr. KENNY. Mr. Chairman, if it is appropriate, we would be happy to submit an estimate as to revenue impact.

Mr. PICKLE. I appreciate that, and the staff will be looking at the revenue figures.

Mr. KENNY. We will do that.

Mr. PICKLE. Thank you all for testifying.

Mr. KENNY. Thank you very much.

STATEMENT OF EDWARD F. HOWARD, PUBLIC POLICY COORDINATOR, THE VILLERS FOUNDATION

Mr. HOWARD. Mr. Chairman, I apologize, there was a mixup on the time that I was given, and I thought I was early. Obviously, I am not. I will be very brief.

Mr. PICKLE. We are glad to have your testimony, and we certainly are not trying to close the committee down in advance of the time. We thought we had heard everyone. You proceed to identify yourself and your organization.

Mr. HOWARD. Yes, sir. My name is Ed Howard, the public policy coordinator of the Villers Foundation, which is based here in Washington, and I am very pleased for the chance to testify. You have my prepared statement, I believe.

Mr. PICKLE. Yes; we do.

Mr. HOWARD. With your permission, I will just briefly summarize the main points in it. Last year, in the Deficit Reduction Act, this committee originated and Congress enacted a series of changes in the law affecting charitable contributions to foundations. Some of those changes were designed, I think a great number of them were designed, to encourage greater contributions to private foundations, but at least for one group of donors, the result was the opposite. That result wasn't the one intended, and my purpose is simply to ask that you deal with that inadvertent adverse effect in the technical corrections bill that you have before you.

Our foundation which is a relatively small one and a relatively new one; it first gave grants back in 1983. We make grants mostly in small amounts and mostly to community and statewide groups that have an interest, as we do, in the low-income elderly, which is our principal focus, and obviously a long-time interest of the chairman's.

The reason we are concerned about the tax laws is very simple. The sole donors for our foundation, Phillipe and Katherine Villers of Massachusetts, are among that group of donors adversely affected by the changes that were made in the 1984 act. Without claiming to be a tax lawyer, let me try to explain what I think the major impact of that was.

Before the 1984 changes, it was permissible for donors to give up to 30 percent of their adjusted gross income, their contribution base, to public charities in the form of appreciated stock. In addition to that 30 percent, they could claim a deduction for contributing appreciated stock to private foundations up to the limit on private foundation giving, which is 20 percent, but the amount of that latter deduction was limited to cost plus 60 percent of the appreciated value. So the effect was to allow donors to deduct contributions up to 50 percent of their adjusted gross income if they were willing, in effect, to pay the premium of getting only 60 cents on the dollar for the contribution to the private foundations.

There is an illustration of how that works on the last page of my testimony. In effect, if somebody has $600,000 worth of adjusted gross income, they would have an overall contributions limit of $300,000. If they wanted to maximize their contributions and maximize their deductions, they would have had to donate $380,000 worth of zero-base stock to get $300,000 worth of deductions. That is the way it would work.

Now, in liberalizing the rules for contributing to private foundations last year—that was a piece of legislation with several different effects—Congress allowed the donor to claim the full value of that appreciated stock gift to private foundations rather than 60 percent. But that had a collateral effect that wasn't as positive; that is, that it got counted under the 30 percent limit for contributions of capital gains property. Prior to that, because you only received 60 percent of the value as a deduction, Treasury did not qualify it as capital gains property, and it didn't count. So if a donor now chooses to, as he might have before, donate 30 percent of his income to public charities, he now faces a limit of zero in deductions for contributions of appreciated stock to private foundations; it is less than 60 percent.

From everything we have been able to learn, that isn't what Congress had in mind. As I point out in my prepared statement, the committee's distinguished chairman described the 1984 changes in his floor remarks as "incentives for additional giving to foundations," and the then ranking minority member of the committee, Mr. Conable, told the House that although the changes didn't go far enough in his view, he thought they were, and here I quote, "a spur to turning around the declining birth rate of private foundations."

We think it is clear that the intent of the 1984 changes was to promote donations to private foundations, and just as clearly one group of donors are being discouraged by those changes from contributing; and if you assume that people are going to act on incentives you put in the Tax Code for them, the illustrations on that last page point out that total donations are going to fall because of incentives that are put into the law.

Now, we think that change was inadvertent and Congress should properly remedy it in the technical corrections bill. With the help of the Council of Foundations, and of an informal foundation lawyers group that understand these issues a lot better than I do, we have come up with a simple proposal for a remedy. Just give those who are adversely affected by it a chance to choose to remain

under the prior rules, the ones that were in effect prior to the 1984 act. It is easy to understand, it is easy to administer, we think it is fair, and we think it should be included in H.R. 1800.

That is the gist of it, Mr. Chairman. I would be happy to try to respond to any questions.

[The prepared statement follows:]

STATEMENT OF EDWARD F. HOWARD, PUBLIC POLICY COORDINATOR, THE VILLERS FOUNDATION

Mr. Chairman and members of the Committee, thank you for this opportunity to testify at these hearings, which are aimed in part at making numerous technical corrections in P.L. 98-369, the Deficit Reduction Act of 1984.

In that Act, Congress moved to encourage contributions to private, non-operating foundations by increasing the share of a donor's income qualifying for a deduction to those foundations, and by allowing a full, rather than partial, deduction for contributions to them of appreciated stock.

Inadvertently, the manner in which that liberalization was made had the opposite effect for some donors. For them, it actually reduced the permitted deductions, a result directly at odds with the thrust of Congress' action. My purpose today is to describe that adverse impact, and to suggest a modest remedy that will carry out Congress' original intent.

First, let me explain the interest of the Villers Foundation in this matter. We are a relatively new foundation, established in 1982 as a result of the philanthropy of Philippe and Katherine Villers, of Concord, Massachusetts. The first grants were awarded in 1983.

The Foundation is interested in the elders of America, with a special emphasis on lower-income elders. It seeks to facilitate public awareness and analysis of poverty among elders in America, and to empower elders to define and undertake their own agenda toward both a society in which there are no artificial barriers to full participation for older men and women, and one in which enlightened public and private policies end the specter of poverty-stricken elders.

The Foundation is pursuing these ambitious goals in a variety of ways. We have brought together important policy makers in fields such as health policy and economic development. We have funded outreach and education work concerning the dependent care tax credit. One grant, to the Center for the Study of Social Policy, financed a study about possible long-term reforms

of the Supplemental Security Income (SSI) Program. Another, to the Georgetown Center for Health Policy Studies, will allow a modest examination of the impact of various Medicare reform proposals, especially as to their impact on lower-income persons. We have joined the Robert Wood Johnson Foundation and a consortium of other funders in launching an in-depth, objective look at long-term care financing options by the Brookings Institution.

The preponderance of our grants, however, are community-wide or statewide in focus, rather than national. The Foundation seeks to enable organizations of older people, and other groups actively engaged on behalf of health care, income, and housing. During its limited history, the Foundation has awarded grants in 23 states.

The Foundation's entire operation -- grants in 1985 are budgeted at just over $2 million -- is financed through the periodic contributions of Mr. and Mrs. Villers.

The reason I have sought this chance to testify before you today is not to share with you my own great personal expertise on technical tax matters -- you will discover its limits soon enough -- but rather to share with you our foundation's concern that the changes made last year in the rules governing charitable deductions will hinder the willingness and ability of donors like the Villers' to continue to support the good work Congress intended to encourage through this section of the tax code.

Situation Prior to P.L. 98-369

Before the enactment of the Deficit Reduction Act, donors were subjected to several different limits on the amount and type of donations they could make to different tax-exempt entities and still qualify for an income tax deduction. Here are the relevant ones:

-- an overall limit of 50% of the donor's contribution base (essentially, adjusted gross income, or AGI) on all charitable contributions;

-- a limit of 20% of AGI on contributions to private, non-operating foundations;

-- a limit of 30% of AGI on contributions in the form of qualified appreciated stock ("capital gain property"); and

-- a reduction (to basis plus 60% of appreciation) in the value of contributions of appreciated stock to private foundations.

As to this last limitation, in recognition of the reduced deduction,

these gifts were not classed as "capital gain property," and therefore not subject to the 30% limit on such property. The practical effect of this interaction was to allow a donor to deduct the full value of appreciated stock gifts to public charities up to 30% of AGI and, in addition, deduct basis plus 60% of appreciation for stock gifts to private foundations (up to the 20% of AGI limit on all gifts to private foundations). A simplified example of this situation is included as part of Appendix B to this statement.

Impact of P.L. 98-369

Congress moved in two ways last year to liberalize the rules affecting gifts to private foundations. First, the limit on contributions was raised from 20% to 30% of AGI. Second, if the gift is of qualified appreciated stock, the donor is now allowed to deduct the full value, rather than 60%, of the stock.

A collateral result of the latter change is that the gifts are now treated as "capital gain property," and, when combined with stock gifts to public charities, cannot exceed 30% of AGI.

In practical terms, that means when a donor contributes appreciated stock to public charities equal to 30%, the effective limit on gifts to private foundations is now zero. No current deduction for them is permitted. While these excess contributions can be carried over for up to five years, a donor who consistently donates capital gain gifts to public charities equal to 30% of AGI will never be able to use that carryover. Appendix B also contains an example of this new situation.

So a limited class of donors -- those whose total gifts of capital gain property, including gifts to foundations, consistently exceed 30% -- is clearly worse off than before.

Impact on Charitable Activity

Congress has crafted a rather complex set of incentives, both positive and negative, that affect the charitable giving of relatively wealthy donors. I must admit there is no way accurately to predict how these donors will respond to these latest changes. To bring the point a little closer to home, we don't know for certain how Mr. and Mrs. Villers will respond to the changes.

Perhaps they will maintain their level of giving to private foundations, and cut back on those to the religious, civil rights and other humanitarian organizations to which they now donate. Perhaps they will opt to maintain their giving level to public charities and scale back their gifts to private foundations

Other private foundations with living donors may well be facing the same situation, either now or, if their donors find themselves with more capital gains property than other possible resources to contribute, in the future. That is why the Council on Foundations, with the help of the informal foundation lawyers group that tracks issues like these quite closely, shares the concerns voiced in my testimony.

The likeliest result, overall, is for private donations to decline. At a time when government spending is becoming a less likely source for funding of social programs, that seems to be a step in the wrong direction.

Proposed Solution.

The proper remedy for the problem described above is, we believe, a simple one: simply allow individuals whom the new rules affect adversely to elect to remain subject to the pre-1984 Act rules. This change will be easy to understand, easy to administer, and fair. It will leave these donors no better off than they were prior to the enactment of the Deficit Reduction Act, but also no worse off.

Appropriateness for Inclusion in H.R. 1800

We are mindful, Mr. Chairman and members of the Committee, of the nature of the bill now before you, the "Technical Corrections Act of 1985." (emphasis added) We realize, as you, Mr. Chairman, stated in introducing the bill, that "this legislation is intended to address only legitimate technical problems, and is not to become a vehicle for substantive changes." We believe that the change suggested in the deduction rules fits squarely within the spirit and letter of that guideline.

We can find nothing in the legislative history to suggest that Congress intended to penalize donors who consistently contribute high proportions of their incomes to charitable enterprises, including private foundations, in the form of capital gains property. To the contrary, it seems clear that, at least to a limited extent, the changes in the Deficit Reduction Act were intended to encourage more giving to private foundations, and to remove some of the existing penalties on those who did so using capital gains property.

-- The percentage limit on contributions to private foundations was increased.

-- For the first time, fair market value was allowed as a deduction of capital gains property.

-- Also for the first time, excess contributions to private foundations can be carried forward for use against future tax liability.

Nowhere does Congress suggest that these changes were intended to do anything but promote greater contributions. In fact, Mr. Chairman, when summarizing these provisions in the House version most of which were retained in what was enacted), of the bill you had this to say:

> The bill contains incentives for additional charitable giving to foundations and removes certain unnecessary or unduly burdensome restrictions that may impede charitable activities.

Despite that clear expression of intent, there is an equally clear unequivocal result: one class of donors to private foundations -- and thus, donations to them -- was harmed by the new law.

We urge the Committee to rectify this unintended result with a narrow, targeted amendment to be included in H.R. 1800.

Thank you for your attention.

THE
Villers
FOUNDATION

1334 G STREET N.W./WASHINGTON D.C. 20005/(202) 628-3030

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January 1985

APPENDIX B

Potential Adverse Impact of 1984 Contribution Changes

on Level of Gifts by Donor with High Capital Gains Gifts

In the following examples, it is assumed that the donor donates only zero-basis capital gains property, and donates the maximum amount for which an income tax deduction is available.

Case No. 1 (Pre-1984 Law)

Contribution base (Adjusted gross income)	$600,000	
Overall limit on deduction for charitable contributions	300,000	
Contributions of capital gains property to public charities		180,000
Contribution of capital gains property to private foundation (yields deduction of $120,000 @cost plus 60% of appreciation)		200,000
Total actual contributions		380,000

Case No. 2 (Post-1984 Changes)*

Contribution base	600,000	
Overall limit for charitable contributions	300,000	
Contribution of capital gains property to public charities		180,000
Contribution of capital gains property to private foundation		0
Total actual contributions		180,000

Case No. 3 (Post-1984 Changes)**

Contribution base	600,000	
Overall limit on charitable contributions	300,000	
Contribution of capital gains property to public charities		60,000
Contribution of capital gains property to private foundation		120,000
Total actual contributions		180,000

*Assumes donor maximizes contributions to public charities.
**Assumes donor maximizes contributions to private foundation.

Mr. PICKLE. Well, I thank you, Mr. Howard. What you are objecting to is the change we made in the law that actually resulted in taking away the incentive tc give. Because of the 1984 law, a donor is really not getting any extra and he just doesn't give. It is a disincentive you are saying in this case, instead of incentive.

Mr. HOWARD. That is right.

Mr. PICKLE. Now, you are asking for an extension. I need to know how this would affect other foundations across the board; will it have the same effect for any foundation?

Mr. HOWARD. Private foundations? Most private foundations, we believe—although in our work with the Council on Foundation. they don't have any numbers to give us—would not be affected, because the money for most foundations comes not from living donors who can change their pattern of giving every year.

Mr. PICKLE. Let me back you up a second. Is the Villers Foundation a public charity?

Mr. HOWARD. No; it is a private foundation.

Mr. PICKLE. Nonoperating foundation?

Mr. HOWARD. Yes, sir.

Mr. PICKLE. If it is a private, nonoperating foundation, and you want an exception for your classification, I am asking you then, would that have any effect on public charities or on private operating foundations, would the same provision affect them, in what way?

Mr. HOWARD. I think there would be an indirect effect. It has no effect directly on the foundation, it has an effect on the donor's ability to contribute. Let me say that if Mr. and Mrs. Villers chose to, they could contribute under the law, as it was changed, every bit as much as they did last year or the year before to our foundation, if their income was the same, but they might have, therefore, to cut down on their contribution to public charities. In effect, they have to choose. So the impact on the recipient organization is an indirect one and one that you can't figure out the exact dimensions of until the donors decide how they are going to split that 30 percent.

If you assume that the donor has only appreciated stock that he or she is going to contribute, then, in effect, what was a 50-percent limit before has become a 30 percent, and they can split it any way they want.

Mr. PICKLE. Let me ask a question, I am asking for information. The staff pointed out the difference between the old law and the new law and what you are asking for. Under the old law, there was a 20-percent cap on capital gains donations to private, nonoperating foundations such as yours, and the donor got to take 60 percent off the appreciation.

Mr. HOWARD. Yes, sir.

Mr. PICKLE. Now under this new law, there is still a 20-percent cap on contribution to your foundation, but the donor gets to take the full fair market value of the stock.

Mr. HOWARD. Yes, sir.

Mr. PICKLE. Now, how is that less favorable?

Mr. HOWARD. It isn't. What is unfavorable about it is a separate and unrelated cap that wasn't touched in the 1984 law—that is a cap on overall capital gains contributions, whether it is to public or

private, of 30 percent. So every dollar in that 20 percent that they gave to a private foundation, which used to be not counted because it was only 60 percent of the value of the gift, is now counted. So if they give 20 percent to a private foundation, they can now give up to 10 percent to the public charities that they were supporting before.

Mr. PICKLE. Is it actually working out that you are making less contributions under the new law?

Mr. HOWARD. In fact, the Villers will make less contributions if they take advantage of the new law and get 100 percent of the contribution value. They can take their maximum tax deduction and get, in effect, $180,000 worth of deductions, in my example for $180,000 worth of stock, where before they would have to have used 60 cent dollars, in effect, to make those contributions.

Mr. PICKLE. I think our committee is going to look into the overall question of how this type of change would affect the public charities or private foundations, because I think we must take that into consideration as you make your request. I can see the point you are getting after. I don't know what the committee would feel; I can understand your concern about it.

Mr. HOWARD. Yes; it really relates to one unfortunate interrelationship among several different caps, and, therefore, it gets pretty complicated, but it does seem pretty clear that no one said, "Let's go and get the people who donate lots of capital property to charities, public or private, and cut their donation limit from 50 percent to 30 percent."

Mr. PICKLE. Well, I thank you very much. I don't have any other questions.

[Whereupon, at 2:30 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

STATEMENT OF THE AIR TRANSPORT ASSOCIATION OF AMERICA

The Air Transport Association of America (ATA) is a trade and service organization comprised of scheduled U.S. airlines. Its members provide over 90 percent of the revenue passenger miles flown by all U.S. airlines. We appreciate the opportunity to provide comments on the Technical Corrections Act of 1985 (H.R. 1800).

One correction we believe needs to be made is to Section 132 (g)(2), entitled "Reciprocal Agreements", in the new Fringe Benefits section. This subsection allows an employer to provide services tax free to employees of another employer if certain conditions are met. These conditions include requirements that (1) the employer providing the service not incur any substantial additional cost (including foregone revenue), and (2) both employers enter into a written agreement, and, implicitly, that (3) both employers be in the same line of business.

ATA is an unincorporated, not-for-profit trade and service organization which falls under Section 501(c)(6) of the Internal Revenue Code. ATA's operations are financed directly by dues payments from its airline members, and its staff fulfill duties that employees of the individual member airlines would have to take on if ATA did not exist. ATA is also reimbursed for expenses arising from the printing and distribution of airline industry-related publications, but it sponsors no conventions or other revenue-generating programs. As a result, the wages paid to ATA's employees come directly from its member airlines.

ATA is one of several similar industry-owned service organizations, which together have a total staff of fewer than 1000 people. These service organizations are necessary to, and support the efforts of the approximately 330,000 airline employees who provide air transportation services within the United States and to foreign countries.

In 1938 the Congress created the Civil Aeronautics Board (CAB) as the expert agency to regulate the air transportation system in the United States. Under the original act (Civil Aeronautics Act of 1938) and its successor (Federal Aviation Act

of 1958), the CAB's pervasive regulation included enforcement of a provision (Section 403) which required airlines to adhere to published tariffs and to sell air transportation only after receiving proper payment. That provision decreed that only airline employees and their families, and certain other very limited groups were to be eligible for free or reduced-rate transportation, and that any airline failure to comply with that mandate was subject to the civil penalties established by Section 901 of the Act (up to $1,000 per violation) and the criminal penalties established by Section 902 of the Act (a misdemeanor calling for fines up to $500 for the first offence and up to $2000 for any subsequent offence).[1]

As early as 1940 the CAB approved a multi-carrier agreement for the issuance of passes to ATA employees, among others, for free or reduced-rate transportation pursuant to Section 403 (b) of the Act. Individual carriers thereafter routinely filed and observed tariffs and company rules which implemented those pass authorizations in accordance with Sections 403 and 404 of the Act and Part 223 of the CAB's Economic Regulations. Later, in response to an inquiry from a related industry-owned service organization, the CAB's general counsel determined that Air Cargo Inc. employees were the "joint employees of proprietary air carriers" within the meaning of Section 403(b).[2]

Airline pass manuals, providing for free and reduced-rate transportation to ATA employees, were routinely filed with, and accepted by, the CAB, and industry resolutions containing similar provisions were approved by the CAB.

In 1963 the CAB considered whether Combined Airline Ticket Office (CATO) personnel were employees of the controlling airlines, and, as such, were eligible for free and reduced-rate transportation. The CAB responded to this inquiry in the affirmative, emphasizing the supervision and control exercised by the airlines and the fact that the functions performed by the CATO personnel would be performed directly by the airlines but for the existence of the CATOs.

The functions performed by the ATA employees are, likewise, directed by its member airlines. Members of ATA staff receive guidance on the issues from member airlines at periodic Board of Directors' meetings and other meetings of airline representatives. ATA conducts no activities outside the directives of its members and its focus is solely on air commerce. It is not an independent entity which serves the airlines and also other persons; it is a creature of the airlines and wholly dependent on them for direction and funding. From the very earliest days, ATA employees have been considered to be airline employees engaged in air commerce and they continue to be so engaged today. As a reflection of this, ATA employees have from the very earliest days been accorded employee pass privileges by the ATA member airlines, and this treatment was reaffirmed for the indefinite future by action of the ATA Board of Directors at its December 1984 meeting.

In summary, in order to avoid any confusion which may arise from the 1984 amendments to the Tax Code, we urge that consideration be given to amending Section 132 (g) to clarify that employees of ATA and similar industry-owned organizations are "airline employees" engaged in air transportation. This change will specifically enable these organizations to renew written agreements with the airlines under which their employees will continue to receive traditional passes and reduced rate air transportation as tax-free fringe benefits. Attached is a proposed amendment to Section 132 (g) which has been drafted to accomplish this objective.

Proposed Technical Amendment

The following should be added to § 132:

"In subsection (g)(2) the word "and" should be deleted at the end of the subparagraph (A), a comma should replace the period at the end of subparagraph (B) followed by the word "and", and a new subparagraph (C) should be added:

> "(C) Either all of such employers satisfy the conditions of paragraph (1) of subsection (b) or one of the employers is an organization described in section 501(c)(6) the membership of which is limited to, or a corporation which is owned entirely by, entities engaged in the transportation of individuals or property for compensation or hire by air, and which organization or corporation is operated in furtherance of the activities of its members or owners.".

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[1] Pursuant to the Airline Deregulation Act of 1978 and the CAB Sunset Act of 1984, jurisdiction over this provision, with regard to international air transportation only, has now been transferred to the Department of Transportation.

[2] Air Cargo Inc. is a corporation of airlines engaged in the development and promotion of a ground support system for the transportation of property by air. It was founded in 1941, and is an integral part of the air freight network.

Statement of the Subcommittee on Health and Welfare Plans of the American Academy of Actuaries

On May 16, 1985, the House Committee on Ways and Means held hearings on the Technical Corrections Act of 1985. The comments below are submitted for the record of those hearings and to the Subcommittee on Labor-Management Relations of the House Committee on Education and Labor.

PURPOSE

The American Academy of Actuaries ("Academy") appreciates the opportunity to submit comments on the Technical Corrections Act of 1985. This document contains comments on issues relating to premium stabilization reserves, setting actuarial assumptions, disability income benefits, and the definition of a qualified actuary.

BACKGROUND

The Academy is a professional association of over 7,600 actuaries involved in all areas of specialization within the actuarial profession. Included within our membership are approximately 85% of the enrolled actuaries certified under the Employee Retirement Income Security Act of 1974 (ERISA), as well as comparable percentages of actuaries specializing in actuarial services for other employee coverages such as life, health and disability programs. As a national organization of actuaries, the Academy is unique in that its membership consists of actuaries with expertise in all areas of actuarial specialization.

The Academy does not advocate major public policy positions, in such areas as tax legislation, which are not actuarial in nature. The Academy views its role in the government relations arena as providing information and actuarial analysis to public policy decision-makers, so that policy decisions can be made with informed judgment. It is our belief that the training and experience of Academy members allow a unique understanding of current practices in employee benefits. Our intention is to communicate that understanding in ways that assist policy decision-makers.

COMMENTS

Premium stabilization reserves

The description of the Technical Corrections Act of 1985 states that certain amounts held by an insurance company for a reasonable premium stabilization reserve may not be treated as a fund for purposes of Section 419.

A premium stabilization reserve, in order to be considered reasonable, should reflect the nature of the coverages to which it applies. A coverage that is characterized by frequent, relatively small claims requires a smaller reserve than a coverage characterized by large, infrequent claims. Furthermore, a larger reserve should be considered reasonable on coverages where fewer lives are exposed. Claim costs can fluctuate significantly from year to year, and a reasonable premium stabilization reserve can provide protection against fluctuation.

The level of reserves which might be considered reasonable also depends on the nature of the group insured. Where a premium is collected directly from individuals covered, it is desirable to maintain those premiums at a stable level from year to year. If premiums increase significantly, covered lives who are generally better risks will drop out of the group. The remaining lives will require further premium increases, and the plan will continue to decline in size. Thus, a stabilization reserve for this sort of group should be significantly higher than for a conventional employer plan in order to prevent a declining enrollment spiral.

Examples of groups where higher levels of reserves are reasonable are employee-pay-all plans, associations of individuals, and to a lesser extent, associations of employers and other multiple employer plans.

The appropriate level of reserves on a particular group can be determined based on type and design of benefit provisions, and the nature of the group covered. This level of reserve can vary from group to group.

Actuarial assumptions

As in any actuarial assignment, the setting of appropriate assumptions is a key ingredient in establishing funding levels. The provisions relating to welfare benefit plans funded through VEBAs in the Deficit Reduction Act of 1984 require that assumptions be reasonable in the aggregate. This is quite appropriate and follows the precedent set by ERISA in the pension area. However, the Conference Report goes further and indicates that "in addition to requiring that actuarial assumptions are

to be reasonable in the aggregate, Treasury regulations may prescribe specific interest rate and mortality assumptions to be used in all actuarial calculations." Such a simplistic approach would ignore the fact that experience is different from plan to plan for a variety of reasons (age/sex composition, benefit utilization tendencies of group, nature of work, geographical area, etc.). Attempting to mandate any set of uniform assumptions will inevitably result in inappropriate assumptions being used for large numbers of plans. Setting appropriate actuarial assumptions requires the application of actuarial judgment to fit the facts and circumstances at hand.

We are concerned at the prospect that specific actuarual assumptions might be prescribed for funded welfare benefit plans. We believe the approach used in ERISA for setting actuarial assumptions for pension valuations is much more appropriate. The treatment of future increases in claim costs on post-retirement benefits is of particular concern. Under the Deficit Reduction Act of 1984, increases in claim costs due to any source such as inflation, changes in utilization patterns, etc. could only be funded each year after the increase has occurred, rather than through advance funding. The net effect is that these limits in general will be substantially below the full, level cost of the benefits promised. This provision effectively discourages employers who wish to adequately fund retiree welfare benefits as they do pension plans.

Definition of disability

The Conference Committee has expressed its intent that with regard to welfare benefit funds established for providing disability benefits that a disability be defined as "any serious physical or mental impairment which causes an inability to perform a substantial portion of the duties of an individual's ordinary employment." The Committee further expressed their intent that funding of claims with respect to an indefinite period of time be allowed only in connection with disabilities that are determined to be long term disabilities. Such disabilities are "those which (1) a medical evaluation determines is expected to last more than 12 months and (2) has persisted for at least five months."

The Conference Committee's definition of disability has two serious defects. First, it does not recognize disabilities that are not expected to last twelve months under a long term disability plan. Many serious disabilities will persist beyond five months, but will terminate either by death or recovery within one year of the onset of disability. Second, the definition requires that the claim persist for at least five months and many long term disability plans employ a shorter elimination period.

There are several definitions of disability which are commonly used in conjunction with disability income plans. The definition which is incorporated into a particular plan document will reflect the plan sponsor's employee benefit philosophies and policies, as well as the level of costs it is willing to incur.

A plan sponsor is not likely to modify the definition of disability within its plan document to conform with the Conference Committee's definition. As a result, one definition of disability would be used for benefit determination and a second would be employed for the purposes of determining qualified funding limits. This qualification of certain disabilities for the purpose of determining funding limits could result in an unrealted business income tax to the fund if it is funded to meet its future obligations according to reasonable actuarial assumptions as to morbidity, mortality and interest. On the other hand, if fund accruals are limited to be in accord with the Conference Committee's definition of disability, the fund may be insufficient to meet its future obligations.

We recommend that a disability income plan funding level be determined using actuarial techniques and reasonable assumptions as to morbidity, mortality and interest reflecting the definition of disability incorporated into the plan document.

Short-term versus long-term disability plans

The Conference Committee limits funding for short-term disability plans to five months of benefit payments. Short-term disability plans most commonly provide for three, six or twelve months of payment. We recommend that a short-term disability plan funding limitations be defined in a manner consistent with the plan maximums.

Definition of qualified actuary

Actuarial analysis of employee welfare benefit plans demands the expertise of specialists in welfare plans, employing actuarially sound methods which reflect characteristics unique to those particular welfare plans. Included are characteristics such as the analysis of past health care utilization, adjustments to reflect the changes of plan design or demographics, assessments of claim liabilities, analysis of claim trends (including inflation and utilization patterns) and projections of finan-

cial experience. Only actuaries specializing in these programs are properly qualified to so examine employer welfare benefit plans. For example, an enrolled actuary under ERISA has satisfied qualification standards for practice in the pension area, but such an individual may or may not be qualified when it comes to employee health and welfare plans. We strongly urge that direct participation of the actuarial profession be utilized in defining necessary qualifications for actuarial services to these plans. The Academy has a strong commitment to professional standards and self-regulation. We are prepared to work closely with the government if regulations regarding actuarial qualifications are to be developed.

SUMMARY

The actuarial profession, as represented by the American Academy of Actuaries, appreciates the opportunity to present our testimony and wishes to offer any possible assistance to the governmental bodies involved with employee welfare benefit plans. Because we understand past and present practices in this area, we believe that we can assist in identifying and weighing the merits of employee benefit plan alternatives for the future. We hope the comments presented in this statement will be useful in helping Congress deal appropriately with the complex area of employee benefits.

AMERICAN ACADEMY OF ACTUARIES

Committee on Health: E. Paul Barnhart, Chairman.

Subcommittee on Health and Welfare Plans: Thomas G. Nelson, Chairman; Alan D. Ford, Anthony J. Houghton, Martin J. Loughlin, William J. Miner, Richard Ostuw, Jeffrey P. Petertil, Thomas G. Ruehle.

STATEMENT OF GENE E. OVERBECK, SENIOR VICE PRESIDENT, GOVERNMENT AFFAIRS, AMERICAN AIRLINES, INC.

This statement is submitted on behalf of Flagship International, Inc., an affiliate of American Airlines doing business under the name of Sky Chefs. Both Sky Chefs and American Airlines are subsidiaries of AMR Corporation.

Sky Chefs is the food service arm of American Airlines. It operates flight kitchens and provides food catering services to American and other airlines at various airports throughout the United States. It also operates restaurants and gift shops at some of these airports.

Before the Tax Reform Act of 1984 became effective, Sky Chefs employees received tax exempt travel privileges on American Airlines. These was no distinction in this regard between an American employee and a Sky Chefs employee. The fact that Sky Chefs was separately incorporated was not deemed significant. The fact that Sky Chefs performed services for other airlines and operated airport restaurants was not deemed significant.

However, enactment of the Tax Reform Act last year changed all that. It placed the status of Sky Chefs employees under a cloud. In the absence of clarification of Section 132 of the law, AMR's tax advisors have concluded that travel privileges on American cannot safely be extended to Sky Chefs employees without withholding tax on the value of these benefits.

The specific question is whether Sky Chefs employees are performing services in the same line of business as American Airlines, namely the air transportation line of business or one of its various components. Because Sky Chefs is separately incorporated, and because its services are not confined to aircraft catering, there is a question in the minds of AMR's tax lawyers whether Sky Chefs employees may be held to be performing services in the food service line of business, rather than in the air transportation line of business.

We believe that a review of the facts justify the following four conclusions: First, Sky Chefs' primary business is the catering of aircraft; second, the catering of aircraft is a function of the air transportation line of business; third, the fact that Sky Chefs is an affiliate rather than a division of American Airlines should not be relevant to a determination of the "lines of business" question; and fourth, the ancillary services performed by Sky Chefs and its employees do not justify a determination that these employees should be treated any differently from those of American with respect to eligibility for tax exempt air transportation privileges.

In reaching these conclusions, we find support in the Standard Industrial Classification Manual published by OMB and utilized by the IRS in determining lines of business questions. For example, it states that each establishment should be as-

signed a code on the basis of its primary activity. It also says that the classification "transportation by air" extends to establishments furnishing terminal services.

In February of this year, a ruling was requested from the Internal Revenue Service on the status of Sky Chefs employees, and that request is still pending. Unfortunately, we have been led to believe that there simply will be no rulings issued in the area of fringe benefits in the foreseeable future because of the IRS view that further legislation and regulatory changes are likely. As a result, Sky Chefs employees find themselves in a kind of no man's land.

It is for this reason that we seek the assistance of the Committee in the technical corrections bill. We do not believe it was the intention of the Tax Reform Act of 1984 to deprive Sky Chefs employees and retirees of a privilege they have enjoyed for over 40 years. Since we cannot obtain the clarification we need from the Internal Revenue Service, and since the uncertainly that exists is working a manifest hardship on these employees, clarification in the technical corrections bill is an appropriate remedy.

If the Committee agrees, the simplest way to accomplishing that clarification is by way of an amendment to Section 531(f) of the Tax Reform Act of 1984. The text of such an amendment was furnished to Mr. Dowley on May 7, 1985. The purpose of Section 531(f), as it reads today, is to clarify the determination of lines of business in the case of retail department store affiliates, and the principle that is now embodied in that section could very simply be extended to airline affiliates such as Sky Chefs.

We urge the Committee to give favorable consideration to this request.

AMERICAN BANKERS ASSOCIATION,
Washington, DC, May 20, 1985.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means, House of Representatives, Washington, DC.

DEAR MR. CHAIRMAN: I am writing on behalf of the nearly 4,000 trust departments of the American Bankers Association's member banks to express our support for Section 105(a) of H.R. 1800, the Technical Corrections Act of 1985.

As enacted in 1984, IRC Section 643(e) requires two or more trusts to be consolidated for income tax purposes if the trusts had substantially the same grantor (treating husband and wife as the same person), substantially the same beneficiary or beneficiaries, and a principal purpose of the trusts is the avoidance of tax.

That law presents enormous difficulties for trustees who do not know, nor, prior to its enactment, had any reason to ask about other trusts which may have been established by the grantor or the grantor's spouse. In most cases the only way a fiduciary could ascertain the existence of other trusts is from the grantors themselves, but they may be deceased. In addition a great many difficulties relating to sharing of information on a timely basis were left to be worked out by fiduciaries.

Section 105(a) would make the 1984 law inapplicable to trusts which were irrevocable on March 1, 1984, except for amounts contributed to corpus after that date. ABA supports this provision. Insofar as it goes it relieves fiduciaries of a seemingly impossible burden.

We understand that Treasury has taken a different position but we strongly believe the provision should remain in the bill as is. While even after adoption of this proposed change a great many details and clarifications will have to be worked out in the regulations, the separation of "old" trusts goes a long way to narrowing the impact of the provision by limiting it to trusts which have been established recently. ABA will be pleased to discuss this proposal in greater detail with the committee staff if that would be helpful.

We request that this letter be made a part of the hearing record of H.R. 1800.

Sincerely yours,

JAMES D. MCLAUGHLIN,
Government Relations Counsel.

STATEMENT OF MALCOLM A. MOORE, CHAIRMAN, ESTATE AND GIFT TAX COMMITTEE OF THE AMERICAN COLLEGE OF PROBATE COUNSEL

The written statement has been prepared by the Estate & Gift Tax Committee of the American College or Probate Counsel (the "College"). The membership of the Estate & Gift Tax Committee of the College is listed on Exhibit B attached to the written statement.

The American College of Probate Counsel is composed of more than 2,450 experienced and seasoned lawyers that specialize in the practice of trusts and estates law and related tax matters. The improvement and reform of probate laws and procedures, with the ultimate goal of simplifying to the maximim extent possible the disposition of property and the administration of estates in this country, has been a major and continuing effort of the College from the day it was first organized over 35 years ago.

The attached written statement relates to Section 6660 (the understatement valuation penalty section enacted as Section 155(c) of the Tax Reform Act of 1984). While part of the statement calls for repeal of that section as it applies to the estate tax, much of the paper relates to technical corrections needed in the statute, whether it applies only to the gift tax, or applies to both the estate and gift tax.

SECTION 6660 SHOULD BE REPEALED AS TO THE ESTATE TAX AND SUBSTANTIALLY MODIFIED AS TO THE GIFT TAX

Section 155(c) of the Tax Reform Act of 1984 added to the Internal Revenue Code an entirely new section 6660, creating an addition to tax in the case of a valuation understatement for purposes of estate and gift taxes. Section 6660(a) provides that the addition to tax is a percentage of the underpayment of tax due to the understatement of value, but section 6660(d) exempts underpayments of less than $1,000. Under section 6660(b), the addition is 10% of the underpayment if the claimed valuation is 50% or more but not more than 66-2/3% of the correct valuation, 20% if the claimed valuation is 40% or more but less than 50% of the correct valuation, and 30% if the claimed valuation is less than 40% of the correct valuation. Section 6660(e) gives the Secretary the authority to waive the addition to tax if the taxpayer shows that there was a reasonable basis for the claimed valuation and that such claim was made in good faith.

It is submitted that this provision requires drastic revision and partial repeal. However, to analyze the section in detail in support of this suggestion, some historical review is required.

Section 6653(a)(1) of the Code provides for an addition to tax if any underpayment of tax is due to negligence or

intentional disregard of rules and regulations without intent to defraud. The addition to tax is 5% of the underpayment. However, section 6653(a)(1) is limited to underpayment of income tax, gift tax and windfall profit tax. It does not apply to underpayment of estate tax. Provision for a 5% penalty with regard to underpayment of income tax originated with section 250(b) of the Revenue Act of 1918. A comparable penalty was added for underpayment of gift tax in the Gift Tax Act of 1932, section 520(a). However, at no time has such a penalty ever applied to underpayment of estate tax, although the 50% fraud penalty imposed by section 6653(b)(1) applies to estate tax as well as to the other taxes mentioned.

The 5% negligence penalty and the 50% fraud penalty for underpayment remained the sole penalties for underpayment until 1981. In that year, the Economic Recovery Tax Act [ERTA] added new section 6659 to the Code, providing for an addition to tax in the case of a valuation overstatement for purposes of the income tax. The addition to tax was expressed as a percentage of the underpayment of tax due to the overstatement of value, with underpayments of less than $1,000 exempted. The addition was set at 10% of the underpayment if the claimed valuation was 150% or more but not more than 200% of the correct valuation, 20% if the claimed valuation was more than 200% but not more than 250% of the correct valuation, and 30% if the claimed valuation was more than 250% of the correct

valuation. The Secretary was given authority to waive the penalty upon a showing that there was a reasonable basis for the valuation claimed and that such claim was made in good faith. Section 6659, as added to the Code in 1981, closely parallels new section 6660 [the undervaluations which give rise to percentage additions to tax under section 6660 are the reciprocals of the overvaluations in section 6659].

In the House Report on ERTA, H.R. 97-201, 97th Cong., 1st Sess., June 24, 1981, pp. 243-244, and in the General Explanation of ERTA, prepared by the Staff of the Joint Committee, the existence of negligence and fraud penalties for underpayment of income tax was noted, but a specific penalty was said to be necessary because of the large number of valuation disputes outstanding [stated to be 500,000]. The House Committee Report also noted that the then interest rate on deficiencies was below the then prevailing cost of borrowing, making overvaluations attractive. In expanding on the new provision and explaining how it would work, the Staff of the Joint Committee gave as its sole example of overvaluation a case of an overvalued painting given to charity.

With a few minor technically clarifying amendments, section 6659 remained as enacted until the 1984 Act. In that Act, in addition to enacting section 6660, Congress took significant action with respect to overvaluations of property.

Section 155(a) of the Act, which is not a part of the Internal Revenue Code, directed the Secretary to issue Regulations requiring individuals, closely held corporations and personal service corporations claiming deductions under section 170 of the Code for contributions of property other than publicly traded securities to obtain qualified appraisals of the property contributed, and to attach such appraisals, plus other information, to the return on which the deduction is claimed.

A "qualified appraisal" is defined as one prepared by a "qualified appraiser" which includes a description of the property appraised, the fair market value of such property on the date of contribution, the specific basis for the valuation, a statement that the appraisal was made for income tax purposes, the qualifications of the appraiser, the signature and TIN number of the appraiser, and any other information required by Regulations. A "qualified appraiser" is one who is qualified to appraise the type of property involved and who is not the taxpayer, a party to the transaction in which the taxpayer acquired the property, the donee, any person employed by or related to any of such persons, or any person whose relationship to the taxpayer would cause a reasonable person to question the appraiser's independence. Further, a appraisal will not be a qualified appraisal if the fee is based on a percentage of the value of the appraised property, unless the fee is based on a sliding scale paid to a generally recognized

association regulating appraisers. Such qualified appraisals are to be required whenever the claimed value of similar items and property contributed to charity (other than publicly traded securities), plus the claimed value of all similar items of property contributed, exceeds $5,000 ($10,000 if such property is nonpublicly traded stock).

Section 155(b) of the 1984 Act added new section 6050L to the Code, requiring charitable donees to file information returns in the event of any disposition of gift property within 2 years of its receipt.

Finally, in section 155(c)(1) of the Act, Congress modified section 6659 to eliminate a previous safe haven for property held by the taxpayer for more than 5 years and to provide that the addition to tax in the case of any underpayment attributable to an overvaluation of property for which a charitable deduction was claimed is a flat 30%, regardless of the percentage of overvaluation. In any such case, waiver of the penalty is not permitted unless the Secretary determines that the claimed value of the property was based on a qualified appraisal made by a qualified appraiser and, in addition to obtaining such appraisal, the taxpayer made a good faith investigation of the value of the contributed property.

In explaining these changes, the Senate Committee Report discussed at considerable length the problem presented by overvaluations of property contributed to charity and the playing of the "audit lottery" by taxpayers claiming excessive charitable deductions. Because of these concerns, the Committee stated that "stronger substantiation and overvaluation provisions should be made applicable to charitable contributions of property." Without further discussion, the Report then commented that the general overvaluation penalty "should apply whether the property is held for fewer or more than five years, and that it is equally important to deter incorrect valuations for estate and gift tax purposes."

From this historical analysis, it is clear that Congress has consistently been more concerned about underpayment abuses in connection with income and gift taxes than the estate tax. While the fraud penalty applies to underpayment of estate tax, the negligence penalty to this day is inapplicable to such tax. Further, when valuation disputes were first perceived as requiring a specific penalty, it was in the context of intentional overvaluation of property for which an income tax deduction was claimed. Although the original overvaluation penalty provisions were not limited to charitable contributions, the legislative history makes clear that such was the principal problem area. The 1984 amendments to section 6659 and subsections (a) and (b) of section 155 of the 1984 Act were directed

at precisely that target. Expansion of the penalties for valuation error to the estate tax area appears to have been no more than an afterthought.

Making inter vivos deductible gifts of property to charity is, self-evidently, elective, and such gifts are widely utilized for income tax reduction purposes. Further, in making such a gift, the donor is able to select the item of property to be donated. Under such circumstances, the temptation to lean a little on the valuation scale so as to obtain a larger reduction of tax is obvious. A similar motivation to value an item of property selected for a taxable gift at the low end of the valuation scale may also be apparent.

However, the estate tax presents an entirely different situation. Assuming that, in most instances, the event which triggers estate tax is involuntary, determination of the correct tax requires the correct valuation of each and every item in the decedent's estate. It is, of course, true that valuation of certain types of assets is difficult and that serious differences of opinion may exist between an estate's representative and an IRS auditor. However, it is not the estate's fault that this is so, whereas it might be contended that problems caused by selection of a difficult-to-value asset for either a deductible or a taxable gift are occasioned by the donor. In light of the lack of legislative history behind the need for an estate tax undervaluation penalty, the apparent lack of abuse in such valuations, and the substantive

and technical shortcomings of the statute set forth later in this document, Section 6660 should be limited to the gift tax until it has been shown that its expansion solves a genuine estate tax problem The existence of such a problem has not as yet been demonstrated. No evidence of egregious or wide-spread undervaluation of property for estate tax purposes has been presented.

Even if it were to apply only to the gift tax, Section 6660 requires significant modification, both substantive and technical. Section 6659(g)(1) defines an "underpayment", to which the penalties imposed by that section apply, by reference to section 6653(c)(1), which, in turn, incorporates the definition of a "deficiency" set forth in section 6211, i.e., the net tax owed. Thus, for purposes of the overvaluation section, no penalty is imposed if there is no deficiency in income tax. Section 6660, however, contains no definition of "underpayment", and presumably the penalty imposed by that section would be due even if a reduction in the value of other items of property eliminated any deficiency. A reference to section 6653(c)(1) is required.

Further, the de minimis exception of section 6660 is far too small in the gift or estate tax context, where gifts will frequently be made to use up a donor's unified credit resulting in transfers in excess of $600,000 by 1987. A $1,000 de minimis exception is simply inadequate. There should be no penalty unless the underpayment represents a significant percentage of the total tax. The 10%-$5,000 test of section 6661 should be incorporated in section 6660.

There will be significant questions regarding whether there has even been an understatement, and if so, how is the penalty to be computed. For example, suppose that three items of property are undervalued. The first is valued at 52% of its correct value; the second at 45%, and the third at 38%. If the effect of the three undervaluations is to cause the marginal tax rate to drop from 49% to 43%, completely by-passing the 45% bracket, how are the penalties to be computed? Should the underpayment attributed to the greatest undervaluation be computed at the highest rate? Should an average rate be used? It is suggested that a technical amendment be adopted to make clear that all valuation understatements should be aggregated and the proper percentage determined with respect to the total and applied to the underpayment resulting therefrom.

Finally, the Regulations should make clear what constitutes a reasonable basis for a claimed valuation, as well as what constitutes good faith in making such claim. Proposed Regulation § 1.6661-6 offers some guidance in this area, but is itself inadequate. At the very least, the Regulations should provide that there is a reasonable basis for a value based on a qualfied appraisal made by a qualified appraiser as those terms are used in section 6659(f). The Regulations should also recognize that, in some cases, comparable property does not exist and, in such cases, even greater weight must be given to a qualified appraisal. Two qualified appraisals should require waiver of the penalty. In addition, the Act should be amended, and the Regulations should be issued consistent therewith, to eliminate any penalty where the taxpayer's

valuation approach is supported by substantial authority such as court decisions supporting use of substantial discounts in the valuation of closely held stock. Even though the IRS does not agree with such decisions and continues to litigate the issue, it should not be entitled to assert a penalty against those who rely on favorable court decisions. See proposed Regulation § 1.6661-3.

The Explanation of the Act should also express Congressional intent that the requirements of good faith and fair play extend in two directions. While taxpayers may be subject to a penalty for undervaluation, no penalty presently applies if the Service asserts an excessive value. Direction should be given to examining officers to temper their enthusiasm for collecting tax with a realistic approach to value. Experience under the Act may ultimately demonstrate the need for enactment of a penalty against the Service if agents utilize section 6660 as a threat to obtain agreement to asserted deficiencies with respect to the putative undervalued asset or on some other basis.

A suggested revision of section 6660 is attached hereto as Exhibit A.

If section 6660 were to remain applicable to the estate tax, further revisions would be required. Under new section 2210, an ESOP may be required to pay a portion of the estate tax otherwise due from an estate which transfers employer securities to it. In such case, under new section 6018(c)(2), the plan administrator is required to file an estate tax return with respect to such portion of the tax. Section 6660 should be amended to make clear that the

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ESOP is not liable for any penalty due to undervaluation.

The addition to tax appears to apply even where the understatement of value results from failure of the estate to qualify for special use valuation under section 2032A. Such a situation does not involve a valuation abuse of the type at which the section appears to be aimed and the section should be amended to make this clear.

Expansion of the de minimis rule is especially vital if the section applies to the estate tax. Even if one were to argue that a $1,000 floor is appropriate with respect to underpayments of income tax or gift tax attributable to voluntary transfers of overvalued property to charity or undervalued property to others (which the College asserts is not the case with the gift tax), it is entirely inappropriate where applied to involuntary transfers subject to estate tax. Without considering such inherently difficult-to-value assets as closely held corporation stock, property subject to options or buy-sell agreements, tax shelter partnerships, mineral interests and the like, virtually all estates will include items such as jewelry, furniture and furnishings, or a residence, as to which valuation estimates may well differ by more than one-third. To apply a 10% penalty in all such cases is intolerable.

EXHIBIT A

SEC. 6660. ADDITION TO TAX IN THE CASE OF VALUATION UNDER UNDERSTATEMENT FOR PURPOSES OF THE ~~ESTATE OR~~ GIFT TAX~~ES~~.

(a) Addition to the Tax.- In the case of a substantial ~~any~~ underpayment of a tax imposed by ~~subtitle B~~ chapter 12 (relating to ~~XXXXXX and~~ gift taxes) which is attributable to a valuation understatement, there shall be added to the tax an amount equal to the applicable percentage of the underpayment so attributed.

(b) Applicable Percentage.- For purposes of subsection (a), the applicable percentage shall be determined under the following table:

If the valuation claimed is the following percent of the correct valuation -	The applicable percentage is
50 percent or more but not more than 66-2/3 percent	10
40 percent or more but less than 50 percent	20
Less than 40 percent	30

(c) Valuation Understatement Defined.- For purposes of this section, there is a valuation understatement if the value of an item of ~~any~~ property claimed on any return is 66-2/3 percent or less of the amount determined to be the correct amount of such valuation unless the value claimed on the return with respect to such item of property is or was supported by substantial ~~XXXXX~~ authority. For purposes of sub-sectio (b), the valuation claimed for all such undervalued items of property shall be determined as a percentage of the correct valuation of all such items.

(d) ~~Underpayment-Must-Be-at-least-$1,000.--This section-shall-not-apply-if-the-underpayment-is-less than-$1,000-for-any-taxable-period-(or-in-the-case-of the-tax-imposed-by-chapter-11,-with-respect-to-the estate-of-the-decedent).~~ Substantial Underpayment Defined.- For purposes of this section there is a substantial underpayment of tax if the amount of the underpayment exceeds the greater of -

(i) 10% percent of the tax required to be paid for the taxable period; or

(ii) $5,000.

(e) Authority to Waive.- The Secretary may waive all or any part of the addition to the tax provided by this section on a showing by the taxpayer that there was a reasonable basis for the valuation claimed on the return and that such claim was made in good faith.

(f) Underpayment Defined.- For purposes of this section, the term "underpayment" has the meaning given to such term by section 6663(c)(1).

EXHIBIT B

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STATEMENT OF THE AMERICAN COUNCIL OF LIFE INSURANCE

Mr. Chairman and members of the committee; the following comments on H.R. 1800, The Technical Corrections Act of 1985, and H.R. 2110, making technical corrections to the Retirement Equity Act of 1984, are offered on behalf of the American Council of Life Insurance ("ACLI"). The ACLI is a trade association representing 615 life insurance companies. Together, these companies hold 95 percent of the life insurance written in the United States and 97 percent of the assets of insured pension plans.

Our comments that follow are divided into two sections. In the first section general areas of concern under H.R. 1800 are discussed and, in addition, further changes in the Deficit Reduction Act of 1984 not covered in H.R. 1800 are suggested. In the second portion of our comments, problem areas under H.R. 2110 are addressed.

I. Comments on H.R. 1800, the Technical Corrections Act of 1985

A. DEFINITION OF WELFARE BENEFIT FUND

Background

Section 151(a)(8) of the technical corrections bill would clarify the definition of welfare benefit "fund" in Section 419(e)(3) of the Code to exclude amounts held by an insurance company pursuant to certain insurance contracts. The legislative history of Section 419 states that the primary purpose of the welfare benefit fund provisions is to prevent employers from taking premature deductions for expenses which have not yet been incurred [H.R. Rep. No. 861, 98th Cong., 2d Sess. 1155 (1984)]. The proposed technical correction implements the Congressional policy that typical group insurance contracts are not subject to the various limitations on welfare benefit funds.

The ACLI urges that the proposed technical correction be enacted. The ACLI is concerned that ambiguous language in the Committee reports underlying the 1984 Act could be misinterpreted to impact adversely on a wide variety of common life, accident and health insurance benefits that are not designed to generate premature deductions. It is essential that the proposed technical correction be enacted to state expressly Congress' intent not to disrupt bona fide group insurance plans which provide the security of insurance protection to millions of employees and their dependents.

Section 151(a)(8) of the bill would exclude amounts held by an insurance company pursuant to an insurance contract if: (1) there is no guarantee of a renewal of the contract; and (2) other than current insurance protection, the only payments to which the employer or employees are entitled are experience-rated refunds or policy dividends which are not guaranteed and which are determined, in part, by factors other than the amount of welfare benefits paid to (or on behalf of) the employees of the employer or their beneficiaries. This statutory exclusion from the definition of fund would apply only where any experience-rated refund or policy dividend payable to an employer with respect to a policy year is treated by the employer as received or accrued in the taxable year in which the policy year ends.

The proposed technical correction would exclude from the definition of "fund" typical experience-rated group insurance plans. The "no guarantee of renewal", "no guarantee of dividend" and "other factors" requirements are included in the technical correction to describe features of bona fide group insurance plans that distinguish such plans from "cost-plus" or "self-insured" arrangements. Because of these features, the premiums paid by the employer are subject to a risk of loss and, therefore, are not to be treated as contributions to a fund.

In practice, the "no guarantee of renewal" feature under a typical group insurance contract takes one of two forms: the insurer has a right for future policy years either to cancel the contract or to change the premium rate. In these insured arrangements, the employer is not guaranteed a return of any part of his premium payments because any experience-rated refund or policy dividend is determined, in part, by factors (e.g., a risk charge) in addition to benefits paid. As a result, the insurer assumes the risk that benefits will exceed premiums paid and the employer assumes the significant economic risk that he will not be refunded any portion of his premiums. Thus, the technical correction would properly exempt the typical experience-rated group insurance policy, but would not exempt cost-plus or similar arrangements based solely on the employer's experience where comparable risks are not present.

Section 151(a)(8) should be enacted

There are several reasons why the proposed technical correction is appropriate and should be enacted. First, the provision recognizes the fundamental differences between insured and uninsured welfare benefit arrangements. Specifically, the employer who provides benefits through an insured arrangement obtains the insurer's benefit guarantees in exchange for premium payments. In return for this third-party guarantee, the employer must forego: (1) potential savings in state premium taxes (typically 2–4% of employer contributions) and other retention charges; (2) the ability to control the investment of his contributions and to establish claims reserves; (3) the ability to control cash flow and the level of contributions to the plan; and (4) discretion in determining administrative practices and charges. The proposed exclusion of insured arrangements does not affect these potential competitive advantages of self-insured arrangements—it simply carries out the Congressional intent that bona fide insured plans, under which the employer has relinquished the control available with self-insurance, were not intended to be subject to the tax law's funding constraints aimed at uninsured plans.

Second, the proposed technical correction minimizes the ability of an employer to obtain current deductions for amounts allocable to future benefits in accordance with the intent of the law. This is because the exclusion would apply only if the employer includes in income the amount of any experience-rated refund or dividend for the policy year to which the refund or dividend relates. Consequently, the provision would not permit arrangements that effectively circumvent the Congressional policy to limit the ability of employers to use the tax laws to benefit from the so-called "time value of money."

Third, the proposed technical correction would provide much needed certainty that common types of insured welfare plans will not be treated as welfare benefit funds. This certainty is essential because: (1) the legislative history of the welfare benefit fund provisions contains substantial ambiguity and potentially confusing language with respect to the intended scope of the regulations under Section 419(e)(3); (2) the new rules are scheduled to take effect on January 1, 1986, but, it is extremely unlikely that final, and possibly even proposed, regulations will be published by that date; and (3) in the interim, the status of thousands of plans covering millions of workers and their beneficiaries is open to question with the potential for substantial disruption if overly broad regulations are issued. Moreover, uncertainty will significantly impede the establishment of new plans. The proposed technical correction would properly remove the existing cloud that hangs over a major segment of this important aspect of the insurance industry.

In its statement before the Committee, Treasury opposed the proposed technical correction in Section 151(a)(8). The ACLI strongly disagrees with Treasury's suggestion that the proposed technical correction be abandoned. Treasury's opposition to Section 151(a)(8) appears to be based primarily on the erroneous premise that insured plans are comparable to self-insurance and that group insurance should be classified as a "fund." But, in enacting the welfare benefit fund provisions, Congress recognized that bona fide insurance arrangements do not involve potential premature deductions or the employer control inherent in uninsured plans. Congress did not intend to subject insured arrangements to the new tax rules. Thus, Treasury's arguments do not warrant deletion of the proposed technical correction.

Treasury did agree, however, that a technical correction is needed to insure that there is no "chilling effect" on the retention or establishment of arrangements offered by insurance companies. Treasury indicates that such a technical correction could provide that an account held by an insurance company will not be treated as a "fund" before six months following the issuance of final regulations. Treasury's statement recognizes that regulations defining particular arrangements as "funds" should not be effective immediately upon promulgation because such regulations may include arrangements which employers reasonably did not believe would be considered "funds." In such situations, employers should have a reasonable opportunity to modify their arrangements to conform to the positions reflected in the final regulations. The industry endorses, therefore, Treasury's suggestion that the law be amended to provide that any arrangements defined in final regulations to be a "fund" will not be subject to the funded welfare benefit fund rules until six months after the promulgation of such final regulations.

Recommendations

For the foregoing reasons, the ACLI strongly recommends that the proposed technical correction in Section 151(a)(8) be enacted and endorses Treasury's suggestion regarding the effective date of final regulations defining "fund." We alsc suggest confirmation that the "no guarantee of a renewal" requirement is satisfied where,

as is the case in typical group insurance plans, the insurer has the right for future policy years either to cancel the contract or to change the premium rate.

B. DISTRIBUTION RULES APPLICABLE TO ANNUITY CONTRACTS

Proposals

1. In Section 126(a) of H.R. 1800, eliminate the reference to annuity contracts described in Section 403(b) (proposed subclause (ii) of Paragraph 5(A) and eliminate the proposal in Section 152(a)(3) of H.R. 1800 to subject such annuity contracts to the distribution rules of Section 401(a)(9) so that Section 403(b) annuity contracts will be subject to the distribution rules of Section 72(s);

2. Clarify whether the distribution rules of Section 72(s) or 401(a)(9) apply to annuity contracts issued in connection with deferred compensation plans meeting the requirements of Section 457 and make it clear that whichever rules apply, they are the exclusive distribution rules for such contracts.

Reasons for change

1. *Section 403(b) annuities.*—Insurers, in order to meet the January 18, 1985, effective date of existing Section 72(s), amended their contracts to include Section 72(s) distribution rules, filing with all of the states in which they do business to obtain the required approval for that action. It was reasonable for our members to assume that the distribution rules of Section 72(s) were what were required since 403(b) annuity contracts are not part of qualified plans and the general intent of Congress in enacting Section 72(s) was to require that annuity contracts incorporate qualified plan-like distribution rules. The distribution rules of Section 72(s) are substantially similar to those of Section 401(a)(9), and to require a switch at this point would accomplish little more than impose significant added administrative burdens and expense on our members who complied with what they reasonably thought Congress required last year.

If the proposal to apply the Section 401(a)(9) distribution rules to Section 403(b) annuity contracts is retained, however, we strongly urge that the effective date provision be changed so as to grandfather existing contracts. If the proposal is unchanged, different requirements will apply to contributions made before and after the date of enactment. This split treatment would require either the issuance of new contracts to current participants or the isolation of existing contract values because of the different distribution requirements, necessitating two calculations for each settlement request. Either alternative would impose unnecessary administrative burdens and costs on our members and 403(b) annuity contractholders.

2. *State and local government deferred compensation plans.*—It is not clear under existing law whether the distribution rules of Section 72(s) or 401(a)(9) apply to annuity contracts issued in connection with deferred compensation plans meeting the requirements of Section 457. We do not have a view as to which set of rules would be more appropriate, but we do urge that in the interest of certainty and efficiency, one of the two be prescribed as the exclusive set of distribution requirements for such annuity contracts.

C. EXCEPTION TO THE PENALTY FOR PREMATURE DISTRIBUTIONS FROM ANNUITY CONTRACTS

Proposal

Subparagraph (B) of Section 72(q)(2) as proposed to be amended by Section 126(c) of H.R. 1800 should be changed to read as follows: "(B) made on or after the death of the holder or annuitant."

Reasons for change

The proposal contained in Section 126(c) of H.R. 1800 would result in a significant substantive change in the law as it has existed since before the enactment of DEFRA. It would impose a premature distribution penalty tax on annuity contract distributions that are triggered by the death of the annuitant unless the annuitant is also the owner of the contract, or unless a person other than an individual owns the contract and the annuitant is also the primary annuitant. As such, the proposal would work a fundamental change in this Internal Revenue Code provision which is not appropriate for technical correction legislation, particularly since it exceeds the scope of the DEFRA amendment to Section 72(q). (The DEFRA amendment eliminated a distinctly different exception to the penalty relating to investments made within ten years of distribution.)

Moreover, the proposal would penalize legitimate business practice with respect to annuity payments. The death of the annuitant under an annuity contract is fre-

quently an event upon which a contract terminates and a distribution under it is required. It is just as appropriate to except from the premature distribution penalty tax a distribution required under the terms of a contract on the death of an annuitant as a distribution required by law on the death of the holder. In both cases, the distribution is triggered by events outside the control of the holder, and since the triggering event is death it seems quite unlikely to spawn abuses or much tax planning. A distribution under an annuity contract upon the death of the annuitant is not a premature distribution, but rather a distribution precipitated by an event which generally causes the contract to terminate and provide for a distribution. It, therefore, should not be subjected to a penalty as a "premature" distribution.

Finally, the proposed effective date of the amendment is not specified. If the proposed amendment to Section 72(q)(2)(B) is not modified as we recommend, it should not be effective until taxpayers who relied on the TEFRA provision under which the penalty was not applicable on the death of the annuitant have had an opportunity to review their contracts. The proposed change to Section 72(q) is no less significant than the proposed changes to Section 72(s) and therefore a period of at least six months following the enactment of the proposal would appear to be reasonable.

D. EXCEPTIONS TO THE EXCISE TAX ON CERTAIN FUNDED WELFARE BENEFIT PLANS

Proposal

Section 151(a)(11) of H.R. 1800 would be amended by adding the following italicized language to the amendment to Code Section 4976:

> "(4) EXCEPTION FOR CERTAIN AMOUNTS CHARGED AGAINST EXISTING RESERVE.—Subparagraphs (A) and (B) of paragraph (1) shall not apply to post-retirement benefits charged against an existing reserve *and any income thereon* for post-retirement medical or life insurance benefits (as defined in Section 512(a)(3)(E).".

Reasons for change

The H.R. 1800 amendment in Section 151(a)(11) provides an exemption from the excise tax provisions of Section 4976 for amounts charged against an existing reserve for post-retirement life insurance or medical benefits. This exemption cross references the unrelated business taxable income provisions in Section 512(a)(3)(E) (as amended by Section 151(a)(10)(C) of H.R. 1800) for the definition of an "existing reserve". For this purpose, an existing reserve for post-retirement life insurance or medical benefits is the amount of assets set aside as of July 18, 1984 for post-retirement life insurance or medical benefits to be provided to covered employees.

A literal interpretation of this amendment provides only partial relief from the excise tax provisions for contributions made on or before July 18, 1984 with respect to post-retirement life insurance or medical reserves. The amendment excludes only an existing reserve, and not the income thereon, from the application of the excise tax. The amendment in referencing "an existing reserve . . . as defined in Code Section 512(a)(3)(E)" makes no mention of the income attributable to such an existing reserve and is therefore technically deficient.

The Blue Book provides on page 794 that the rules for the application of the excise tax should be similar to the rules which apply to the analogous provisions with respect to unrelated business taxable income. Both existing reserves and any income thereon are exempt from the unrelated business income tax. See Section 512(a)(3)(E). No policy reason exists to impose an excise tax on the income of an existing reserve while at the same time exempting that same income from the unrelated business income tax.

E. INCOME COMPUTATION FOR A FAILED LIFE INSURANCE CONTRACT

Proposal

In Section 221 of the Deficit Reduction Act of 1984 which adds Section 7702: At Section 7702(g)(1)(D)(ii): delete the parenthetical phrase "(computed on the basis of 5-year age brackets)."

Reasons for change

Section 7702(g)(1)(D) provides that income calculated with respect to a contract which fails the definition of life insurance includes, among other items, the "cost of life insurance protection" based on the lesser of two items: the contract's mortality charge or a cost based on rates prescribed by the Secretary. While a straightforward application of this approach would suggest a direct comparison of the costs determined under the two methods to determine the lesser, this will often produce an inappropriate result. This is because of two facts:

1. The Secretary's rates must (because of the parenthetical expression in Section 7702(g)(1)(D)(ii) be based on 5-year age brackets, presumably reflecting an average assumed cost over the 5-year interval;

2. The overwhelming majority of explicitly stated mortality costs in life insurance contracts are specified for each age, rather than by age brackets.

Thus, for example, if monthly costs are $.35, .37, .40, .43, and .48 for each year of a particular 5-year interval, the Secretary's prescribed rate for that interval might well be $.41. The result then would be the use of $.35, .37, and .40 for the first three years, and $.41 for the last two years.

This clearly erroneous result can be avoided by allowing the Secretary to prescribe a specific rate for each insured age (together with rules for computing average rates over various sized intervals for comparisons with contract rates which are specified for age brackets, if that is also thought appropriate). The 5-year bracket requirement seems to be borrowed from Code Section 79(c); however, in that context no harm is done since no comparisons are made: The prescribed rates are the sole rates used. In this context, it places an unnecessary and inappropriate constraint on the Secretary.

F. ANNUITIES USED TO COMPENSATE FOR SICKNESS OR INJURY

Proposal

Add an exception from the distribution rules of Sections 72(s) and (q) for annuity contracts that are used to fund payments which are excluded from gross income under Section 104(a)(1) or 104(a)(2) of the Code.

Reasons for change

Annuity contracts are commonly used to fund payments of compensation or damages on account of accident or sickness when the payment is structured to be periodic rather than paid in a lump sum. These arrangements are commonly referred to as structured settlements and involve three parties: (1) a defendant (the person liable for making the payments) or a structured settlement company (a company that assumes the defendant's liability); (2) the insurer (the funding agent); and (3) the injured party (the ultimate recipient of payments funded by the annuity contract). The payments to the injured party are exempt from income tax under Section 104(a)(1) or 104(a)(2) of the Code. Those payments are made either according to a schedule imposed by a settlement of the injury or sickness claim or a court order. That schedule or court order usually varies the amount of payment, for example, to cover medical expenses, and sometimes provides that payments extend beyond the time of death of the injured party.

The defendant or structured settlement company may be subject to the Section 72(q) penalty for annuity payments it receives from the insurer, for example, when the settlement requires payments that vary in amount. We do not think that this situation should be equated with a premature distribution from an annuity contract that Congress sought to penalize when it enacted Section 72(q). In addition, it would be inappropriate to impose a penalty on the defendant or structured settlement company for a payment that would be exempt from the penalty if received directly by the injured party (because of that payment's exclusion from gross income). Finally, Congress recognized the use of annuity contracts to fund structured settlements when it enacted Section 130 (dealing with the taxation of the structured settlement company).

Similarly we urge that structured settlement annuity contracts be exempt from the requirements of Section 72(s). The injured party, the ultimate recipient of payments in a structured settlement, is not taxed on those payments and therefore has no direct tax incentive to seek deferral of payments. Thus, we think that the reason for the required distribution rules do not exist in this situation.

G. SPECIAL RULES WHERE HOLDER IS NOT AN INDIVIDUAL

Proposal

Subparagraph (6)(A) of Section 72(s) as proposed to be added by Section 126(b)(1) of H.R. 1800 should be changed by adding the following italicized language:

> "(A) IN GENERAL.—For purposes of this subsection, if the holder of a contract is not an individual, *or is an individual acting in a representative capacity,* the primary annuitant shall be treated as the holder of the contract.".

Reason for change

The effect of the proposed amendment is not clear where the holder is one acting in a representative capacity and the representative is an individual. We believe our

suggested addition would further the intent of the Bill by including in the treatment of a primary annuitant as holder, the situation in which an individual holds the contract in a representative capacity such as a custodian or trustee. In such a case, the individual has no beneficial interest in the contract and therefore it would be inappropriate to require a distribution upon his death. Moreover, while the individual may die, the capacity in which he holds the contract (e.g., trustee) does not cease to exist.

H. EXEMPTION OF PRE-1985 ACCUMULATIONS FROM PENALTY ON PREMATURE DISTRIBUTIONS

Proposal

In Section 152(a)(2)(A) of H.R. 1800 change the last clause of the paragraph which reads ". . . clause (i) shall not apply to amounts attributable to contributions paid before January 1, 1985." to read as follows: ". . . clause (i) shall not apply to amounts attributable to contributions in a defined contribution plan or benefit accruals in a defined benefit plan with regard to plan years beginning before January 1, 1985."

Reasons for change

In a defined benefit plan it would be particularly difficult and quite arbitrary to relate an amount of a distribution to contributions paid before or after a specific date. We think that since amounts available for distribution in a defined benefit plan are determined by benefit accruals, benefit accruals are a more appropriate and workable measurement for the proposed grandfather treatment. In addition, since benefit accruals generally relate to a plan year rather than a calendar year accounting period, the proposed grandfathering would be more workable if made effective for plan years beginning before January 1, 1985.

Similarly, we think that records kept for defined contribution plans relate contributions, and associated investment performance, to plan year accounting periods. For this reason, we suggest that the effective date for defined contribution plans also be the plan year.

II. Comments on H.R. 2110, the Retirement Equity Act Technical Corrections Act

A. EFFECT OF THE RETIREMENT EQUITY ACT ("REA") ON SINGLE PREMIUM ANNUITY CONTRACTS

While the ACLI applauds efforts to correct technical problems under REA, we are disturbed that H.R. 2110, the Retirement Equity Act Technical Corrections Act, leaves unaddressed very significant issues regarding terminated plans that were so superficially treated in REA. We think it fair to say that throughout Congressional consideration of REA, there was no contemplation that all of the procedural requirements of that legislation would be extended past plan termination. While we support the basic protections provided plan participants by REA, it has become clear to us since enactment that, when considered in the context of the group annuity arrangements purchased by plan sponsors as part of the process of winding up the affairs of the plan, certain REA provisions impose unnecessary expense and uncertainty on employers and insurers.

Typically, when a plan sponsor of a terminated defined benefit plan winds up the affairs of that plan, it purchases a single premium non-participating group annuity contract ("SPAC"), under which the entire benefit rights of each plan participant are fully guaranteed through an irrevocable commitment issued to the plan participants by a private insurer. Prior to enactment of REA, participants who elected a lump sum payment of their benefits were permitted, under the regulations of the Pension Benefit Guaranty Corporation ("PBGC"), the agency charged with the enforcement of ERISA's plan termination provisions, to irrevocably elect this benefit option and receive an immediate distribution in lieu of the insurer's commitment to provide an annuity at retirement age. This procedure predated purchase of the annuity arrangement and was effectuated by the plan sponsor—not the insurer. In lieu of a cash payment, a participant could elect to be covered by the annuity contract (choosing any of a variety of annuity options) generally determined as of the annuity commencement date and calculated using the insurance company's interest rates and actuarial factors, as specified in the contract negotiated at plan termination between the insurer and the sponsor of the terminating plan. Once a participant elected to receive a commitment to an annuity few, if any, insurers permitted a later election of a lump sum payment.

We recognize that certain of the new requirements imposed by REA necessitate appropriate adjustments in the rules governing plan terminations. So, for example, participant elections in favor of a single life annuity or a lump sum should require spousal consent, even if a plan is terminating. Similarly, elections with respect to benefit options that are made by the participant at the time the plan terminates appropriately should be converted using the interest rates and factors specified in the plan prior to plan termination, as required by Code Section 401(a)(25) and Revenue Ruling 79-90.

Beyond these requirements, however, are a variety of REA imposed procedural requirements which ignore the distinctions between a terminated plan and an ongoing plan. Mandated application of these requirements as the exclusive method of complying with the survivor benefit and anti-cut-back provisions of REA violates the long-held premise of our private pension system that plan establishment and termination are voluntary and that, after plan termination, a participant's rights under an ongoing plan are settled.

While it may be appropriate to protect past accruals in an ongoing plan after a plan amendment, participants in a terminated plan have no expectation of future service or benefit accrual after the date of termination. Accordingly, the ACLI believes there is a clear qualitative distinction between an amendment to an ongoing plan and the termination of a plan. After plan termination, rights which attach to an individual's status as a plan participant are no longer protected. Just as participants are no longer credited with additional vesting and no longer entitled to periodic reports with respect to their benefit rights, summary plan descriptions and the like, it is fundamentally inconsistent with the notion of terminated plans to permit unlimited revocability of benefit elections, additional benefit entitlement based on events occurring after the date of plan termination, and the continuing imposition of the notice and recordkeeping obligations of an ongoing plan sponsor on the insurer.

In the context of plan termination, the insurer is no more than a vendor of a product required under the law to effectuate a plan termination under Title IV of ERISA. The insurer's product is fully regulated under state law, and its obligations to former plan participants derive from the contractual relationships between the individual annuitant and the insurer, rather than from the provisions of the now terminated plan. An employer who decides to establish and maintain an ERISA-covered and tax qualified plan thereby obligates itself to conform to the rules imposed by those statutes. The issuance of a SPAC in satisfaction of a plan's liabilities under Title IV should extinguish the plan administrator's obligations and not, as has been suggested by some since REA, merely transfer his obligations to the insurer of the annuity guarantee. This position is clearly embodied in the Department of Labor's regulations under ERISA defining "employee benefit plan" (29 CFR 2510.3-3) and also in the PBGC regulations defining "participant" for purposes of premium payments (29 CFR 2610.2).

Our detailed comments on specific issues relating to SPAC's where further technical corrections to REA are needed follow below.

1. *Treatment of optional forms of benefits.*—Section 301 of REA amended Section 411(a)(6) of the Code and Section 204(g) of ERISA to provide that a plan amendment which, with respect to benefits attributable to service before the amendment has the effect of eliminating an optional form of benefit, shall be treated as an amendment reducing accrued benefits. The anti-cut-back rules of REA Section 301 further provide that a participant's accrued benefit is only considered to be reduced if the removal of the optional form of benefit results in the participant's loss of a "valuable right". The Secretary of the Treasury is given authority to issue regulations relating to conditions under which the removal of an optional form of benefit will and will not be regarded as the removal of a valuable right.

Under the new statutory rules, optional forms of benefits are treated, for purposes of the anti-cut-back requirements, in some fashion as a participant's accrued benefit. Furthermore, it is possible that regulations ultimately issued will interpret the assumptions, interest rates and conversion factors used by a plan to calculate the amount of a participant's benefit under any particular optional form of benefit as forming part of a participant's accrued benefit which may not be reduced by a plan amendment. Such a position, particularly in the small plan area, would create serious problems for insurers who issue SPAC's to fund a terminated plan. More importantly, this position would, in many instances, increase the costs of terminating plans and ultimately decrease benefits for participants and beneficiaries.

As it is highly likely that an insurer's current internal interest rate assumption for lump sum distributions will be considerably higher than that used by the plan or PBGC, the opportunity is created for adverse selection against the insurer by the

participant. Since little or no protection for such adverse selection currently exists, an insurer would be forced to charge a higher price to protect against this risk. Similar results arise in the case of subsidized optional forms of payment where the extent of utilization of the option cannot be reasonable predicted at the time of plan termination.

To resolve this problem, the ACLI suggests that a technical correction to REA be enacted to provide that, upon plan termination, only the participant's initial choice of benefit need be governed by the anti-cut-back in accrued benefit rules. Under this approach, a participant would be given a one-time right to select any optional form of benefit using the plan's assumptions, conversion factors, interest rates and procedures for determining actuarial equivalence. After having made this one-time election, a participant could later choose a different form of payment (limited to those previously available under that plan which provide "valuable rights").

Under the ACLI proposed rule, the insurer would provide the participant with the same alternatives as if the plan had continued. The only exception would be that, for subsequent changes after the initial election by the participant, the insurer's (rather than the plan's) interest rates, conversion factors and procedures for determining actuarial equivalence for optional forms of benefits could be used. This change would allow appropriate distinctions between ongoing and terminated plans and would allow plan amendments in an ongoing plan to be properly subject to the anti-cut-back rules, without encompassing amendments to terminated plans in a way that would make termination more expensive and complicated.

2. *Qualified preretirement survivor annuities and qualified joint and survivor annuities.*—Another area of substantial concern in our industry relates to the interaction of two prominent sections of REA concerning Qualified Pre-Retirement Survivor Annuities ("QPSA's").

Section 203 of REA provides for the furnishing of a QPSA—an annuity to a surviving spouse equivalent to 50% of the participant's accrued benefit. At the same time, REA Section 301 prohibits a cut-back in accrued benefits, and treats certain cut-backs in early retirement benefits, retirement-type subsidies and optional benefit forms, as cut-backs in accrued benefits.

Prior to the passage of REA, it seemed clear that a pre-retirement death benefit was not part of the accrued benefit nor was it treated as such. This position was embodied in the Internal Revenue Code Section 411 regulations, which excepted death benefits from the definition of "accrued benefits" (Treasury Regulation Section 1.411(a)-7(a)(1)).

Section 301 of REA does not mention survivor benefits as a type of benefit to be treated as an accrued benefit. On the contrary, the legislative history expressly states that death benefits are not to be considered as a "retirement-type subsidy" under Section 301 such that the anti-cut-back provision would be applicable (See Cong. Rec. of Aug. 2, 1984—S9679 and S9680.)

In light of this fact, the ACLI believes the QPSA to be outside the scope of the anti-cut-back rules. However, in the event this position is not adopted, we believe the survival of the QPSA is only workable if there is a clear definition of who is the "surviving spouse" in the case of a terminated plan for purposes of REA survivor benefits and the spousal consents necessary to the waiver of any such benefits.

The treatment of this problem by the Technical Corrections Act (H.R. 2110) in an analogous area—that of plan loans—is instructive. In the plan loan area, where the pledging of an accrued benefit as collateral may well have an impact in the future—and a negative impact on a different spouse—H.R. 2110 recognizes that spousal consent to the pledge at the time of the loan will control the impact in the future even if there is a different spouse at that time.

The ACLI suggests that those considerations which are inherent in the above noted loan provision proposal may well be even more pertinent in the area of plan termination. We also suggest that the protection of the individual who is the spouse as of plan termination—despite subsequent occurrences—is not inconsistent with, and may be in furtherance of, the policies underlying REA. It is, after all, the "termination date" spouse who has shared in the marital partnership with the plan participant during the years of benefit accrual.

With regard to plan termination, spousal consent is a particularly troublesome problem by virtue of Internal Revenue Code Section 417, as added by Section 203 of REA, which states that a plan must provide a Qualified Joint and Survivor Annuity ("QJ&S") to a married participant unless such participant waives that benefit with the consent of his or her spouse.

In the case of the QPSA, the election period which would require spousal consent extends to the participant's death. In the case of the QJ&S, that election period (together with the necessity of spousal consent) begins 90 days prior to and ends with

the annuity starting date (the date as of which the payments under the plan commence).

Internal Revenue Code Section 417 (a)(2)(B) states that ". . . Any consent of a spouse (or establishment that the consent of a spouse may not be obtained) under the preceding sentence shall be effective only with respect to such spouse."

In the context of an ongoing plan where the relationship among the respective participants, plan sponsor and plan administrator is normally subject to adjustments (particularly in the area of marital status) there is perhaps less concern regarding these matters.

The difficulty arises, however, when the plan has terminated and (perhaps) the plan sponsor is no longer in existence. The plan has sought a guarantee of its obligations through purchase of annuity contracts or certificates but to a large extent the guarantee is imposed upon what may be a fluid situation.

Thus, a variety of questions arise in the area of plan termination, survivor benefits and spousal consents concerning the timing of events, for example:

If the plan has terminated and the participant is single at the time, would a subsequent marriage necessitate a spousal consent to the form of benefit chosen? In the absence of such consent, would the benefit need to be converted into a QJ&S? What if the benefit has been distributed and has been partially or fully utilized?

If the participant, single at plan termination but subsequently married, dies prior to the annuity starting date, would a QPSA have to be provided for the spouse?

Again, in the context of a terminated plan, assume a participant is married and a QJ&S is provided for, would subsequent divorce negate that survivor benefit?

If that participant remarries, which spouse is entitled to the survivor benefits?

If the prior spouse had consented to an alternate form of benefit, does that consent have any impact on the subsequent spouse?

The law would seem to say that in all these circumstances events subsequent to the plan termination may still have to be accounted for. The ACLI believes, however, that such a rule places the insurer in an untenable situation.

The purpose of a plan buying annuities is to provide guarantees and certainty with respect to its obligations accrued to the date of the plan's termination. We suggest that it would be in furtherance of that policy which requires such guarantees and in furtherance of the underlying policies of REA if, for purposes of IRC Section 417, the surviving spouse is defined as the spouse as of the date of plan termination for purposes of the provisions relating to survivor benefits and the notices and consents pursuant to those benefits.

3. *Notice requirements.*—As amended by REA, ERISA Section 205(c) and IRC Section 417(a)(3) require plans to provide participants with written notice of the requirements of a QJ&S and the rights and elections associated therewith, including the requirement that a spouse's consent is needed to waive the joint and survivor benefit. This notice must be provided within a reasonable period of time before the annuity starting date. Similarly, an explanation of the QPSA must be provided to each participant sometime during the period when the participant is between ages 32 and 35.

ERISA Section 205(c)(6) and IRC Section 417(a)(5) provide that, for separated participants, the applicable election period for the QPSA cannot begin later than separation from service. Although the notice requirement contained in ERISA Section 205(c)(3)(B) and IRC Section 417(a)(3)(B) does not explicitly explain when notice should be given for terminated employees, because notice should precede the election period it would appear that in such cases notice would be given between ages 32 and 35, but not later than separation from service.

These provisions cause serious administrative problems for insurers issuing SPAC's to terminated plans. After plans have been terminated it is very difficult for an insurer to properly give notice to covered employees. In the case of an ongoing plan, the nexus of employment enables the plan administrator to keep accurate and current records of the marital status, age and work status of covered employees. An insurer, by contrast, is not in a position to do so. The problem is severe where the termination is accompanied by the employer's closing of operations. In such a situation the insurer has no one to turn to to ascertain the location and the marital status of the participant. The problem is also acute where participants are still employed by the plan sponsor after plan termination. Because the insurer is not in a position to know when an employee severs employment, it can hardly know when to provide notice for the qualified pre-retirement benefit.

The ACLI proposes that in the case of terminated plans notice should be given to employees at the time of plan termination. In our view this would be both an easy and equitable solution to the above-described problem. At the time of plan termination the employee population is well defined. Furthermore, at that time there is

always a plan administrator (independent of whether the employer plans to continue operations) from whom the insurer can get the information which it needs to properly provide notice. Significantly, the purpose of REA would not be compromised under the proposal. At the time of termination, employees are most alert to their rights under a plan and a notice would therefore have its most meaningful impact.

4. *IRC section 411(d)(6), ERISA title I section 204(g) and ERISA title IV.*—REA prohibits amendments which cause cutbacks in accrued benefits, subsidies, early retirement benefits or optional forms of benefits. Neither the Code nor the parallel ERISA Title I provision deals with termination of a plan.

To avoid the possibility of regulatory duplication and conflict, we propose an amendment to both Code Section 411(d)(6) and ERISA Section 204(g) which would state that nothing therein affects the rules and principles established in ERISA Title IV and PBGC regulations for terminated plans.

As the statutes now read, Title IV continues to be supreme in the plan termination area. Since the enactment of ERISA, Title I and the Code have both prohibited the cutback of accrued benefits. Despite the fact that neither statute provided an exception for terminated plans, accrued benefits have been routinely reduced in terminating plans with assets sufficient to cover guaranteed benefits but insufficient for all benefits. In these cases, assets have been allocated and benefits distributed by guaranteed annuity certificates in accordance with PBGC rules and practice. There is nothing in the statutes themselves after REA to change this. Only the Senate Finance Committee Report suggests a change (S. Rep. No. 98–575, p. 31 (1984)).

It is our view that the question of the benefits to be provided by a terminated plan should be resolved exclusively under the provisions and principles of Title IV—the only Federal statutory scheme dedicated solely to plan terminations. Title IV deals comprehensively with all the issues surrounding the plan termination event including the priorities in which benefits are to be provided and the conditions to be continued post-termination. Purporting to extend Section 411(d)(6) to provide authority for creating asset allocation and benefit priority rules and post-termination procedures will create confusion, conflict and uncertainty through unnecessary regulatory duplication and in certain cases will result in reduced accrued benefit coverage. A technical correction such as we propose would provide a single clear consistent rule for plan terminations—the rules developed under Title IV of ERISA.

5. *Retirement-type subsidies.*—Section 301 of REA amended Code Section 411(d)(6)(B) and Section 204(g) of ERISA to provide that a plan amendment that has the effect of eliminating or reducing an early retirement benefit or a retirement-type subsidy with respect to benefits attributable to service before the amendment is treated as a prohibited reduction in the participant's accrued benefit. In the case of retirement-type subsidies, this prohibition applies only with respect to a participant who satisfies (either before or after the amendment) the pre-amendment conditions for the subsidy. Moreover, Rev. Rul. 85–6 (IRB 1985–5, p.10) provides that in a proposed termination of a defined benefit pension plan, the plan will fail to meet the requirements of Code Section 411(d)(6) as amended unless an early retirement subsidy is provided for participants who satisfy the pre-termination subsidy requirements after the termination of the plan.

In the case of a terminated plan, the insurer who issues a SPAC must make assumptions as to the number of plan participants who have not satisfied the conditions for the subsidy prior to termination of the plan but will eventually qualify for the subsidy after the plan terminates. Since the risk is uncertain the insurer must use a conservative (and costly) assumption to price the SPAC. This makes the price of a SPAC more expensive than if eligibility for the subsidy were more certain at the time of plan termination. Moreover, the insurer is often required to do costly administrative work to determine who becomes eligible for the subsidy and when that occurs. While it is possible that in many cases, such as the one described in Rev. Rul. 85–6, an employee can satisfy the conditions for the subsidy after termination of the plan, it is also true that in many cases the conditions for eligibility for the subsidy can never be satisfied after the plan terminates. For example, a plan may provide that to be eligible for the subsidy an employee must complete a certain number of years of plan participation (in addition to meeting an age requirement). In such cases, an employee cannot receive credit for additional years of plan participation in any year following the year of plan termination. Similarly, a contributory plan may require a certain number of years of service (in addition to the attainment of a specified age) to be eligible for the subsidy. Under these plans, employees do not get credit for years of service unless they contribute to the plan. Since no contributions are made to a terminated plan, no additional years of service are earned by employees. Finally, under certain conditions employees would not be able to satisfy

a service requirement after the termination of a plan if the employer who previously maintained the terminated plan was no longer in existence (due to a sale, spin-off, acquisition, bankruptcy, etc).

To resolve this problem, the ACLI proposes a technical correction to REA to provide that retirement-type subsidies must be provided to employees who have not satisfied the conditions for the subsidy prior to plan termination only if it is possible under the terms of the plan immediately prior to plan termination to satisfy the conditions for the subsidy after the plan terminates.

B. OTHER COMMENTS

Our section by section comments on areas where we believe H.R. 2110 (the "Act") needs further clarification or correction follow below:

1. *Act section 2(a)(1)(A).*—We suggest that the change to paragraph (4) of Section 411(d) be modified by the addition of the words "as an employee" so that it reads ". . . participant was performing services for the employer as an employee as of the close. . . ." This change would explicitly distinguish employees from independent contractors who are not eligible for benefits or credit under this method.

2. *Act section 2(b)(2)(A&B)(i).*—It is our understanding that Code Section 401(a)(11)(B)(iii)(III) will not be triggered by a rollover since, in order for a participant to have received a distribution which he or she can roll over, the joint and survivor requirements would already have had to have been satisfied by the plan making the distribution. In light of this, we believe the reference to "indirect transfers" in Act Section 2(b)(2) should be deleted, since this language would seem to apply only to rollovers. In this way, the provision would only cover a direct trustee-to-trustee transfer.

3. *Act section 2(b)(2)(A&B)(ii).*—We suggest that this provision, clarifying transferee plan rules, be modified to read ". . . if the plan separately accounts for these assets and any income therefrom." In our view, a plan should be able to set up a segregated account for transferred assets only, but not have segregated accounts for other assets and still satisfy the purposes of this paragraph.

4. *Act section 2(b)(4).*—Under this section of the Act, a spouse must agree in writing to a loan to the participant if any part of the account balance is pledged as security. Only if such consent is obtained may the plan foreclose on a defaulted loan. The effective date of this provision is April 18, 1985.

Obviously, April 18 has already passed and loans are still being negotiated under the requirements of existing law. Accordingly, we believe the effective date of this provision should be changed to the date of enactment.

In addition, we assume that the requirements for spousal consent under this loan provision are the same as for spousal consent to an election under Code Section 417(a)(2). If this is the case, we suggest that this be explicitly stated in the statute.

5. *Act section 2(c)(4)(A)(v).*—While the change to add subparagraph (A) to Code Section 414(p)(9) is necessary, the limitation in subparagraph (B) to the present value of payments to an alternate payee of $3,500 creates a real problem and should be eliminated.

First, the $3,500 amount is, in our opinion, too low. Under Code Section 414(p)(4), an order may require a distribution significantly in excess of $3,500 before a participant has separated from service.

Moreover, using the entire value of the accrued benefit as the appropriate limit is inconsistent with the provisions of Code Section 411(a)(7), which provides that "the plan may disregard service performed by the employee with respect to which he has received (i) a distribution of the present value of his entire nonforfeitable benefit if such distribution was in an amount (not more than $3,500) permitted under regulations. . . ." If the change in Section 401(a)(11) was not deliberate, a suggested clarification is to insert the word "nonforfeitable" following "If the present value of any". If this change was intended, inserting the words "the nonforfeitable portion of" following "$3,500," would clarify the provision.

In this regard, we note that a similar ambiguity exists in Code Section 417(e)(1) and (2)(A). To eliminate any question, in both cases the words "nonforfeitable portion of the" should be inserted before the words "present value" the first place it appears.

6. *Act section 2(d)(1).*—The change in the rules for the explanation of a distribution eligible for rollover treatment should not be made retroactively effective (as is the case by virtue of Act Section 3). Such retroactive application in our view unfairly creates a compliance requirement which no one could reasonably have foreseen. We suggest instead that this change be made effective as of the date which is no less than six months after the date of enactment.

7. *Act section 2(f)(1).*—While this retroactive protection against a double death benefit liability is very welcome, it seems unfortunate that it must be limited to the period before the plan year beginning in 1985. As a practical matter, there are numerous plans relying on old prototype documents or which, for various reasons, will be slow to comply with these new requirements until the first death under the plan occurs. There seems to be no good reason why this provision could not be redrafted to apply on a permanent basis to any situation where the pre-retirement survivor annuity requirements are in effect. Such a change would not lessen protection for the spouse and it could significantly improve the chance of the plan being able to provide benefits to the remaining participants.

C. ADDITIONAL ITEMS

In addition to the corrections noted above, the ACLI believes that several additional items should be added to H.R. 2110 to clarify Congressional intent regarding the changes made by REA. These additions are as follows:

1. *Clarification of Code section 417(c)(2).*—REA Sections 103 and 203, amending Code Section 401(a)(11) and adding Code Section 417, should be changed to clarify Section 417(c)(2), the "Special Rule for Defined Contribution Plans". Currently, it is unclear whether 50% of a participant's account balance is a minimum to be applied to provide the qualified pre-retirement survivor annuity as otherwise determined by Section 417(c)(1), or if paragraph (2) applies in lieu of paragraph (1). Since applying only 50% of a participant's account (both vested and non-vested amounts) could result in a lesser death benefit for a spouse than would have been required before REA, there can be a significant difference between the two interpretations.

2. *Clarification of Code section 417(f)(2).*—REA Sections 103 and 203, adding Code Section 417, should be changed to clarify Section 417(f)(2), which is the definition of annuity starting date. This paragraph provides: "The term 'annuity starting date' means the first day of the first period for which an amount is received as an annuity (whether by reason of retirement or disability)." Based on a literal reading of Section 417(f)(2) it is possible that, for participants who would receive lump sum payments, certain requirements of Section 417 might not be met because no "annuity" payment is made. A suggestion to prevent this is to add the words "or could be" following "for which an amount is". This change would also clarify the beginning date of the qualified joint and survivor benefit election period by effectively starting the election period 90 days before the earliest retirement age.

3. *Modification of Code section 417(a)(3)(B).*—Code Section 417(a)(3)(B) should be modified by deleting the words "preceding the plan year". As revised, subparagraph (B) would read: "Each plan shall provide to each participant, within the period beginning with the first day of the plan year in which the participant attains age 32 and ending with the close of the plan year in which the participant attains age 35. . . ." This would permit the notice and election procedure to occur at the same time, which would be administratively simpler and make it more likely that the participant would act upon the information provided.

4. *Clarification of Code section 411(a)(7).*—A change should be made to Code Section 411(a)(7) to clarify the status of a participant who separates from service without any nonforfeitable interest in the plan. Currently, it appears possible that unless there is an explicit cash-out, the forfeited funds associated with that participant cannot be made available to reduce employer costs. Yet, with a zero percent vested employee, no cash-out is possible—since nothing is owing to that individual by the plan.

To resolve this potential problem, we suggest that Code Section 411(a)(7) be modified to provide that a participant who separates from service with no vested interest would be deemed to have received a cash-out and his or her accrued benefit can be forfeited. Under this rule, the participant will suffer no detriment so long as: 1) the plan is required to restore the forfeited amount if the participant is re-employed; and 2) the participant would have been able to additionally vest in the accrued benefit had he or she actually received a cash-out and repaid that cash-out upon such re-employment.

Another problem with this same section involves the right of a participant who has received a cash-out of his or her accrued benefit to have a forfeiture restored upon repayment of the cash-out. Prior to REA, Reg. Section 1.411(a)-7(d)(2)(ii)(D) provided that the right of repayment expired two years after the date of re-employment. To prevent any potential record-keeping and funding problems, we suggest that a provision be added to the Act to clarify that the pre-REA two year rule continues to apply to post-REA cash-outs.

5. *Clarification of Code section 411(a)(11).*—A provision should be added to the Act to clarify how to determine the present value of an accrued benefit for purposes of the Section 411(a)(11) restriction on mandatory distributions. Currently, subparagraph (B) of Section 411(a)(11) provides, in essence, that to determine the amount of present value to test against the $3,500 threshold, the interest rate used may not be greater than the rate used by PBGC for determining the present value of a lump sum distribution at plan termination. The statute is not clear as to whether a plan may test the amount of present value using the PBGC rate, and then recalculate the present value using a different, perhaps higher, interest rate for the actual distribution.

This ambiguity could be resolved by striking the words "For purposes of subparagraph (A)," and replacing them with the words "Solely for purposes of determining the amount under subparagraph (A),".

6. *Form of annuity.*—A provision should be added to the Act to clarify that a spouse who is to receive a preretirement survivor annuity may elect a form other than a life income.

We appreciate the opportunity to comment on H.R. 1800 and H.R. 2110. If you need any additional information we will be happy to furnish it to you.

AMERICAN COUNCIL ON EDUCATION,
DIVISION OF GOVERNMENTAL RELATIONS,
Washington, DC, May 29, 1985.

Re H.R. 1800 (Technical amendments to the Tax Reform Act of 1984).

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means, House of Representatives, Washington, DC.

DEAR MR. CHAIRMAN: On behalf of the American Council on Education, an association representing over 1,500 colleges, universities, and other organizations in higher education, we urge you to include in H.R. 1800, the legislation making technical amendments to the Tax Reform Act of 1984 (Public Law 98-369), one change in section 117(d) of the Internal Revenue Code of 1954 (section 532 of the Act): "exclusion of certain reductions in tuition from gross income." Section 117(d) should be amended to provide expressly that union-represented employees shall be disregarded in determining whether the nondiscrimination standard imposed by subsection 117(d)(3) is satisfied.

The nondiscrimination provisions of other sections of the Code commonly include such an exception, for example sections 105(h)(3)(B)(iv) and 410(b)(3)(A). These provisions recognize that, as a result of collective bargaining, the interests of union-represented employees are adequately protected. A union should be able to choose, on behalf of the employees it represents, one form of compensation (for example, additional wages) over another (for example, tuition reduction benefits) without any constraint imposed by the Code's nondiscrimination provisions.

In the absence of an exemption for union-represented employees, many institutions of higher education will be required to deny their highly paid employees tax-favored tuition reduction benefits, to forgo providing tuition reduction benefits altogether, or to extend those benefits to union-represented employees regardless of whether tuition reduction is a benefit that the union wishes to obtain. That result is not consistent with either the purpose of section 117(d), which was to allow institutions to continue to provide tuition reduction on a tax-favored basis in accordance with past practice, or with national labor policy, which encourages employers and unions to bargain freely over wages and fringe benefits.

Arguably, the Internal Revenue Service could provide the needed exception in the anticipated regulations implementing subsection 117(d)(3). However, there are indications that the Service is reluctant to do so, absent positive legislation. To our knowledge, this issue was not considered by the members of the Committee or the full House during enactment of the Tax Reform Act of 1984. While the matter is of some importance to the nation's colleges and universities, we believe it is in no way controversial and should therefore be included in H.R. 1800.

We greatly appreciate your consideration of our request, and we welcome any questions you might have regarding this matter. We also respectfully request that a copy of this letter be included in the record of the Committee's hearings on this proposed legislation.

Very truly yours,

SHELDON ELLIOT STEINBACH,
General Counsel.

AMERICAN HEALTH CARE ASSOCIATION
Washington, DC, May 28, 1985.

Subject: Technical Corrections Act (H.R.1800) changes to Deficit Reduction Act, section 631(b)(2)(A)—Effective dates: Property financed with tax-exempt bonds required to be depreciated on straight-line basis.

Hon. DANIEL ROSTENKOWSKI,
Chairman, Committee on Ways and Means, Washington, DC.

DEAR CHAIRMAN ROSTENKOWSKI: The American Health Care Association would like to propose changes to the Technical Corrections Act of 1985, H.R.1800.

First, Deficit Reduction Act section 631(b)(2)(A)(i) states: "The original use of which commences with the taxpayer and the construction, reconstruction, or rehabilitation of which began before October 19, 1983."

To the DEFRA language H.R.1800 would make the addition, following "1983." ". . . and was completed on or after such date, or, ..."

The concern we have with the amending phrase is that it is a substantive change that retroactively alters the affect of the law on certain projects. Specifically, this additional language would retroactively restrict the refunding of projects to those completed on or after October 1983. The refunding of projects is an allowable practice available under the existing statutory provisions to projects completed before October, 1983 as well as those completed "on or after such date".

Under clause (i), AHCA members have entered negotiations to refund some projects completed before October 19, 1983 by amending the calculation of their interest rate. The refunding is not for the purpose of increasing the amount of the bonds nor to extend the maturity date. Therefore, the refunding in such cases would have no material cost affect to the Treasury. We recommend that refunding of projects existing before October 19, 1983 be grandfathered and therefore be treated on the same basis as under the existing statute.

Second, clause (ii) states: ". . . with respect to which a binding contract to incur significant expenditures was entered into before October 19, 1983."

The Technical Corrections Act would amend clause (ii) by the insertion of the following italicized phrases: ". . . with respect to which a binding contract to incur significant expenditures *for construction, reconstruction or rehabilitation* was entered into before October 19, 1983, and *some of such expenditures are incurred on or after such date.*

In the report on H.R.1800 prepared by the Joint Committee on Taxation, discussion of clause (ii) on page 115 includes the word "acquisition" in the qualifying phrase "significant expenditures for construction, reconstruction or rehabilitation." The Report language reflects the authority as it has been applied under the statute before and after enactment of the Deficit Reduction Act.

An "acquisition" has been historically included by statute in the same use category as "construction, reconstruction, or rehabilitation." We would submit that the Report language is correct and the term "acquisition" should be inserted in the H.R.1800 language for clause (ii). To omit the "acquisition" from the statute would retroactively cause substantive change in the application of the subsection.

I would like to thank the Committee in advance for their consideration and should you, or your staff, have any questions regarding this matter, please do not hesitate to call.

Sincerely,

PAUL R. WILLGING, Ph.D.,
Deputy Executive Vice President.

STATEMENT OF JAMES ALBERTINE, DIRECTOR OF GOVERNMENT AFFAIRS, AMERICAN SOCIETY OF ASSOCIATION EXECUTIVES

The American Society of Association Executives ("ASAE") is pleased to have the opportunity to present a written statement for the printed record of the May 16, 1985 hearing of the Committee on Ways and Means, U.S. House of Representatives on H.R. 2110, a bill making technical corrections to the Retirement Equity Act of 1984 ("REA") and H.R. 1800, The Technical Corrections Act of 1985.

ASAE is headquartered at 1575 Eye Street, N.W., Washington, D.C. 20005 (202–626–2703) and is the professional society for executives who manage trade and professional associations as well as other not-for-profit voluntary organizations in the United States and abroad. Founded in 1920 as the American Trade Association Executives with 67 charter members, ASAE now has a membership of over 11,000 individuals representing more than 6,500 national, state, and local associations. In turn,

these business, professional, educational, technical and industrial associations represent an underlying force of more than 55 million people throughout the world. The overwhelming majority of ASAE's member represent tax-exempt organizations, most of which are either tax exempt as trade associations under Section 501(c)(6) of the Internal Revenue Code ("Code") or tax-exempt as educational or charitable organizations under Section 501(c)(3) of the Code. Many of ASAE's member associations sponsor qualified retirement plans and voluntary employee beneficiary associations ("VEBAs") and other funded welfare plans for their members and their employees. As a result, ASAE is an interested party to legislative activity in these areas.

This written statement contains comments on two topics in H.R. 2110. First, the cashout rules under Section 411 of the Code, including the appropriate Pension Benefit Guaranty Corporation ("PBGC") interest rate to be used and the purpose for which it is to be used. Second, the minimum survivor annuity rules in Section 417 of the Code, including the pre-age 35 waiver rules and the form of payment restrictions. This written statement also contains comments on the funded welfare plan rules in H.R. 1800 that modify Sections 419 and 419A of the Code, with emphasis on the rules on deemed unrelated income, disqualified benefits, the safe harbor limits and the more-than-10-employer exemption.

I. H.R. 2110

H.R. 2110 addresses certain technical corrections in REA. ASAE believes that certain additional areas of REA require clarification.

A. Cashouts

REA amended Section 411 of the Code (relating to minimum vesting requirements) to add a new Section 411(a)(11). The new Section provides as follows:

"(11) RESTRICTIONS ON CERTAIN MANDATORY DISTRIBUTIONS.—

"(A) IN GENERAL.—If the present value of any accrued benefit exceeds $3,500, such benefit shall not be treated as nonforfeitable if the plan provides that the present value of such benefit could be immediately distributed without the consent of the participant.

"(B) DETERMINATION OF PRESENT VALUE.—For purposes of subparagraph (A), present value shall be calculated by using an interest rate not greater than the interest rate which would be used (as of the date of the distribution) by the Pension Benefit Guaranty Corporation for purposes of determining the present value of a lump sum distribution on plan termination.".

This provision, in ASAE's view, is unclear as to which PBGC interest rate should be used and for what purposes.

(1) *What rate applies.*—The PBGC periodically issues a schedule of four interest rates depending on whether an immediate or deferred annuity is to be purchased. There are three deferred interest rates depending on the annuity commencement date of the participant. ASAE understands that many plans have, in the past, used the PBGC immediate annuity rate as the applicable PBGC interest rate in all situations. ASAE also understands that the PBGC would require a lump sum on plan termination to be valued based on the full range of PBGC interest rates. ASAE believes that a technical correction should be made to REA to clarify that the full range of PBGC interest rates is intended to be used for purposes of Code Section 411(a)(11) and other Sections of the Code and ERISA that reference the PBGC interest rate for purposes of the $3,500 cashout rule. This rule could also be used for purposes of determining present value under Section 2(c)(4)(A) of the bill (relating to payment to an alternate payee under a qualified domestic relations order).

(2) *For what purpose is the PBGC interest rate to be applied.*—REA appears to limit the use of the PBGC interest rate to determine whether the consent of a participant to a cash-out must be obtained i.e. whether the amount of a benefit exceeds $3,500. However, it has been suggested that REA also requires that the PBGC interest rate should also be used to determine the amount to be paid in a lump sum. ASAE believes this to be an unwarranted reading of REA. ASAE suggests that a technical correction to REA be adopted to clarify that the interest rate specified in a plan may be used to determine the actual amount to be distributed in a lump sum. This clarification is necessary to approve current plan practices and to avoid plans incurring additional costs in paying out lump sums. ASAE recognizes that there should be safeguards in the law to prevent a plan from using an unreasonably high interest rate. This will not affect the vast majority of plans that are using a range of rates, e.g. from 5% to 9%, that are reasonable.

(3) *Determination date.*—Section 411(a)(11) of the Code, on its face, requires that a lump sum be valued as of the date of distribution for purposes of determining whether the consent of a participant to a cash-out must be obtained. The Senate

Finance Committee Report provides that the PBGC interest rate as of the first day of the plan year in which the distribution occurs may be used throughout the plan year if the plan so provides. ASAE believes that this is an important administrative rule. ASAE recommends that this rule be included as a technical correction to REA.

B. Minimum survivor annuity

Section 2(b) of the bill would make several technical changes in the new survivor annuity rules added by REA. ASAE believes two additional clarifications are in order.

(1) *Pre-35 waiver of qualified preretirement survivor annuity.*—REA requires that a waiver of the qualified preretirement survivor annuity be made during the "applicable election period". This term is defined in Section 417(a)(5)(B) of the Code, generally, as the period beginning on the first day of the plan year in which the participant attains age 35 and ending on the date of the participant's death. A participant's waiver is valid only if the spouse consents. It would appear that an election by a participant before the plan year in which the participant attains age 35 is invalid. Also, it would appear that while a participant must generally be at least 35 years old to waive this statutory death benefit, the spouse need not be 35 years or older to consent to such a waiver. In ASAE's view, it is unfair to prescribe by law that an adult cannot make a knowing and intelligent decision to waive his benefit before he is 35 years old. The consequence of this rule is that many young adults may be required to make a gift of monies received as a qualified preretirement survivor annuity to other members of their family to provide for the security of those family members. Unfortunately, this may result in adverse income and gift tax consequences that could otherwise have been avoided if the participant and his spouse would have been permitted to decide for themselves how the death benefit should be payable. In this regard, ASAE would also suggest that a technical change to REA provide that a waiver of a qualified preretirement survivor annuity (or a qualified joint and survivor annuity) not be treated as a transfer of property for purposes of the gift tax rules under the Code. This can be accomplished by expanding the rule in Section 2(f)(1) of the bill, which now applies only to waivers by participants who perform service after January 1, 1976 and who separated from employment by August 23, 1984. Or this rule can be eliminated to avoid the negative implication that a waiver will result in a gift tax in all other similar situations. To avoid unnecessary problems such as this one, ASAE recommends that a technical correction to REA clarify that a waiver by a participant before he reaches age 35 (and the consent of his spouse at any age) is valid. Alternatively, if Congress determines that a permanent election cannot be made before age 35, a participant should be permitted to make a binding election before age 35 and should be required to make another election at age 35. Although, this additional step would create an administrative burden, it will enable adults, who in all other respects are able to make legally effective decisions, to control the disposition of their death benefit entitlement under the plan.

(2) *Form of payment of qualified joint and survivor annuity and qualified preretirement survivor annuity.*—Code Section 417, added by REA, defines a qualified preretirement survivor annuity as a benefit in a specified amount payable as an annuity i.e. for the remainder of the life of the spouse. This form of benefit may be waived during the applicable election period. REA does not specify whether a participant (with his spouse's consent) or a spouse (upon the participant's death) may elect that the statutory benefit be paid in the form of a lump sum. ASAE believes that it would be in the best interest of the surviving spouse to allow this death benefit to be paid as a lump sum. ASAE recommends that a technical correction to REA so provide.

II. H.R. 1800

The Technical Corrections Act of 1985 addresses certain technical changes in the Deficit Reduction Act of 1984 ("DEFRA"). ASAE believes that certain additional areas of DEFRA should be clarified.

A. Deemed unrelated income on welfare benefit funds

DEFRA added a new Section 419A(g) to the Code (relating to deemed unrelated income on welfare benefit funds). ASAE is concerned about the application of this rule to association sponsored welfare plans.

There are many welfare plans sponsored by associations which either have never been tax-exempt under Section 501(c)(9) of the Code or upon the issuance of the final regulations will no longer be tax exempt. Code Section 419A(g) together with the General Explanation of the Revenue Provisions of DEFRA prepared by the Staff of

the Joint Committee on Taxation (bluebook), at page 792, imply that the unrelated income is taxed to the employer. Since welfare benefit funds may consist of many employers, it would be difficult to assess income taxation against the employers participating in the plan. In addition, this could result in double taxation because certain trusts would pay income taxes and the participating employer would also pay income taxes on the same income. Therefore, the deemed unrelated income rule should not apply to employers participating in more-than-10-employer VEBAs. If a tax is to be applied, it should apply at the trust level.

Section 151(a)(9) of the bill, which would add a new Section 419A(g)(3) (relating to coordination of the deemed unrelated income tax on an employer with the rules in Section 419 on qualified cost), attempts to avoid double taxation. For the reasons discussed above, this Section should exclude association sponsored funded welfare plans. If the tax on deemed unrelated income is applied at the trust level, this Section would not be applicable to association sponsored funded welfare plans.

B. Disqualified benefits

Section 151(a)(11) of the bill amends the definition of disqualified benefit in Section 4976(b) of the Code as used for purposes of the excise tax rules on certain funded welfare benefit plans. Section 4976(b)(1)(C) would benefit fund reverting to the benefit of the employer." ASAE believes that an additional exception to the scope of Section 4976(b)(1)(C) should be provided to clarify that an excise tax will not apply to an experience refund to an employer or a return of a required "run out reserve" i.e., a reserve that must be held for the sole purpose of paying "run out claims" (those claims that are incurred before plan termination but are not paid until after plan termination).

C. Safe harbor limits

Section 151 of the bill contains amendments to the funded welfare benefit rules in Sections 419 and 419A of the Code. ASAE believes that the safe harbor rules in Section 419A(c)(5) of the Code should be clarified to provide that they do not take into account reserves that must be held for the sole purpose of paying "run out claims" or for reserves that are held solely for the purpose of retroactive premium arrangements. This interpretation is authorized by the bluebook, at page 778, in the discussion about retired life reserves or premium stabilization accounts which provides, "However, it is intended that Treasury regulations may exclude from the application of these rules a fund under which the residual asset value of these reserves would be immaterial." In most, if not all, cases the residual asset value of these reserves would be immaterial in relationship to the size of the fund during its operation. This clarification would enable Treasury, without any additional legislative changes, to interpret the law in this manner when it issues regulations. This exclusion would make the safe harbor limits much more acceptable to most association-sponsored welfare funds.

D. Funded welfare plans

DEFRA added new Sections 419 and 419A to the Code (relating to funded welfare plans). The Technical Corrections Act of 1985 in Section 151 contains various technical clarifications to the welfare benefit plan rules. ASAE is concerned about an area that although not currently in the Act, is mentioned in the bluebook as an area in which a technical correction may be necessary.

The literal language of Code Section 419A(f)(6), as amended by DEFRA, creates an exception from the requirements of Code Sections 419 and 419A for a welfare benefit fund which is a part of a ten-or-more employer plan, because it states "This subpart shall not apply . . ." (emphasis added). The bluebook, at page 779, provides that this provision does not apply to deductions for contributions to certain ten-or-more employer plans. Further, page 791 of the bluebook states "[t]he limit on the set-aside is intended to apply to more-than-10-employer VEBAs which are exempt from the deduction limitations". The footnote provides that a technical correction may be necessary so that the statute reflects this intent. As ASAE maintained during the legislative process in connection with DEFRA, the limit on the set-aside should not be extended to plans which have more than 10 employers as participating employers in these plans because these funds do not permit an individual employer to control the operation of the VEBA. Therefore, the competition in the marketplace naturally limits the amount of the reserve. Also, if reserves are insufficient, it is very difficult, if not impossible, to assess any insufficiencies against employers who are no longer participating in these programs.

ASAE would like to express its gratitude to the Committee for the opportunity to submit this written statement.

STATEMENT OF EDWARD E. BURROWS, CHAIRMAN, GOVERNMENT AFFAIRS COMMITTEE, AMERICAN SOCIETY OF PENSION ACTUARIES

RECOMMENDED IMPROVEMENTS IN DEFRA AND REA TECHNICAL CORRECTIONS BILLS

The American Society of Pension Actuaries is a national professional society whose 2,000 members provide actuarial, consulting and administrative services to approximately 30% of the qualified retirement plans in the United States.

A. SUGGESTED MODIFICATIONS OF DEFRA CORRECTIONS

(1) *The pre-59½ distribution penalty transition provisions.*—Under the proposed bill, amounts attributable to contributions paid before January 1, 1985 are exempted from the penalty. The exemption should be changed so that it applies to amounts accrued before January 1, 1985. In the case of a defined contribution plan, this would include amounts actually credited as well as amounts with respect to which the employer's obligation to make the credit had become fixed. It would also apply to later adjustments for investment changes on these January 1, 1985 balances. Without these changes, the bill presents two administrative problems.

(a) Respecting defined contribution plans, it will be necessary to track forfeitures reallocated after January 1, 1985 and determine whether they are attributable to contributions made before that date.

(b) Respecting defined benefit plans, it is not clear what accruals are attributable to what contributions.

Our suggested modifications overcome both problems.

(2) *The 70½ distribution requirement for 5% owners.*—The bill should provide clarification on these points:

(a) Is the 5% owner who reached 70½ long before DEFRA subject to the special distribution requirement?

(b) Consider the individual who is not a 5% owner at age 70½ but becomes one later. Is he subject to the requirement, and if so, when?

(c) Relative to effective dates, it should be made clear whether the first key April 1st is April 1, 1985, or April 1, 1986.

(3) *Definition of a welfare fund.*—The proposed bill attempts to provide "clarification" regarding circumstances in which an insurance company arrangement constitutes a welfare fund. The proposals do not reflect current practices regarding retentions and experience rating. Under these practices, the contract itself does not provide a guaranteed experience rating formula. However, the extra-contractual arrangement between the insurer and the contract-holder always assures that a formula will be followed. This distinction between form and practice should be recognized. The original intent of DEFRA will probably be best served if the proposed "clarification" is deleted.

B. DEFRA CORRECTIONS WHICH SHOULD NOT BE MADE

(1) *Repeal of IRC* § 2517.—This proposal is substantive and does not appear to constitute an appropriate subject for a "technical corrections act." The proposed repeal would impact any irrevocable participant election of an annuity form which provides death benefits payable to a non-spouse. This tax treatment would apply at the time the election becomes irrevocable. This would be the case, for example, if a joint and survivor annuity were elected naming a non-spousal joint annuitant. § 2517 probably should not be repealed even as part of a substantive tax act. What should be included is an amendment to § 2517 exempting the employee's spouse as well as the employee. Without this amendment, there will be a gift whenever the spouse consents to an election away from spousal protection under § 417.

(2) *Amendment of IRC* § 401(h).—The proposed change extending new restrictions to all key employees and not just 5% owners is also substantive and inappropriate for a "technical corrections act." There is no indication that DEFRA was unclear on the application of the new restriction. There is no indication that statutory language was in any way at odds with Congressional intent. It is not appropriate to justify the proposed change on the basis of bringing § 401(h) into line with new welfare fund rules. The difference between the two sets of rules goes beyond the question of which employees are subject to the new separate account requirement. For example, the two sets of rules are different on the issue of unrelated business taxable income. They are different, as well, on the issue of reversion upon plan termination. Finally, they are different on the question of anticipating inflation.

C. SUGGESTED MODIFICATIONS OF REA CORRECTIONS

(1) *Status of defined contribution qualified pre-retirement benefits.*—There should be an acknowledgement that qualified pre-retirement death benefits in defined contribution plans are fully subsidized whenever account balances are not forfeited upon death. It should also be acknowledged that § 417 currently has some shortcomings in failing to deal with this particular type of fully subsidized death benefit. These rules should be considered for this fully subsidized benefit:

(a) The prohibition against opting out before age 35 does not apply.

(b) The requirements for notice and consent do apply. The notice requirement should provide for notice "within a reasonable period after the individual becomes a participant."

(2) *The requirement to use PBGC-acceptable interest rates.*—This issue involves the rules on involuntary settlement of an amount whose value does not exceed $3,500. The rule respecting PBGC-acceptable interest rates should only apply to determining whether a benefit is eligible for involuntary lump sum settlement. It should not apply to determining how much the settlement should be. Determinations relative to the amount of settlement should continue to be subject to the plan's basis of actuarial equivalence. To extend the PBGC-acceptable rate to determination of the amount will lead to discontinuities between lump sum settlements and other forms of settlements. These discontinuities will lead to such bizarre settlement forms as installments for two years certain.

If it is felt desirable to regulate plan definitions of actuarial equivalence more closely than at present, new rules should be carefully worked out and should be applied to all forms of settlement.

(3) *Amounts to which the $3,500 test applies.*—There is confusion regarding the amounts to be taken into consideration in applying the $3,500 test.

These rules should be considered:

(a) The test is made after subtracting any non-vested amounts.

(b) Amounts subject to the test include mandatory employee contribution account balances.

(c) Amounts exclude voluntary employee contribution account balances.

(4) *Treatment of lump sum settlements and in-service distributions for spousal consent purposes.*—There is a good deal of uncertainty within the retirement plan community over whether lump sum settlements and in-service distributions are subject to spousal consent rules. This uncertainty should be eliminated either by statutory correction or by regulation. It seems clear that both transactions must be subject to spousal consent rules—assuming the profit-sharing exemption is inapplicable.

(5) *Restrictions on deferred annuities for terminated employees.*—Vested terminators from defined benefit plans which do not subsidize the pre-retirement spousal benefit represent very difficult administrative problems. In this and the next item, we are suggesting two avenues to elimination of these problems.

Under one avenue, a plan sponsor would be permitted to force the employee into a deferred annuity which includes a pre-retirement death benefit regardless of the former employee's marital status. The death benefit would ordinarily be the termination-time lump sum value of the deferred annuity plus interest to date of death. If the normal form of benefit did not include such a pre-retirement benefit, the terminating employee would find himself forced into a deferred annuity with a lower monthly payment than would have been the case under the normal form.

By providing that there is always a pre-annuity-commencement-date death benefit, the plan administrator sidesteps a difficult fact-finding problem. The problem is to determine, at the former employee's annuity commencement date, how much of the time between employment termination and the annuity commencement date the former employee had been married.

The point to be clarified in the technical corrections bill is that restricting vested terminators to deferred annuities which always include pre-retirement death benefits is not a cut-back. Before REA, the plan probably did not incorporate any such restriction.

(6) *Locking in the vested terminating employee's election at time of termination.*—In the preceding section, we suggested one method of avoiding a potentially difficult administrative problem relative to vested terminators.

A second method would be to freeze the employee's status at time of employment termination. If the employee made an election with spousal consent at time of employment termination, the spousal consent would never again be required, for any later change in election. This rule would apply whether or not the employee is married to the same spouse at time of annuity commencement. The employee who is single at time of employment termination would not be subject to spousal rules at

any time thereafter. The employee who, at time of termination, is married and unable to obtain spousal consent would be forever locked into an annuity containing the pre-retirement death benefit. Furthermore, that death benefit would be related to the survivorship of the individual to whom the participant had been married at the time of termination.

(7) *Treatment of non-deductible employee contribution account balances.*—The proposed bill should be revised to clarify treatment of non-deductible employee contribution account balances relative to qualified pre-retirement death benefit provisions. Treatment appears clear in defined contribution plans: 50% of the account is subject to pre-retirement spousal benefit rules. Treatment is unclear in defined benefit plans.

One option is to apply defined contribution rules to the employee contribution account balance. There is an analogue for this approach in the application of § 415 provisions.

The other option is to convert the account balance to an accrued benefit of the same form as the employer-financed accrued benefit. Then, the employee-financed accrued benefit would be added to the employer-financed benefit. Defined benefit spousal rules would be applied to the total.

This second option leads to differences in treatment of employee contribution account balances depending on the type of plan (defined benefit or defined contribution) of which they are part. The first option appears preferable.

(8) *Treatment of employee deductible contribution balances.*—The bill should clarify treatment of deductible employee contribution account balances relative to spousal annuity provisions. At present, these accounts appear subject to all spousal annuity rules. However, policy in the past has been to maintain consistency between treatment of these accounts and treatment of IRA account balances. Accordingly, we believe failure to exempt deductible employee contribution account balances from the spousal annuity requirements was an oversight which should be corrected.

(9) *Clarification of the 50% rule.*—In a defined contribution plan, the qualified pre-retirement death benefit is defined by reference to "50% of the account balance." Most, but not all, defined contribution plans provide for full vesting of the account balance upon death. Many observers believe that for those plans which do not provide full vesting upon death, the 50% reference was intended to mean 50% of the vested balance. There should be clarification on this point.

(10) *Treatment of loans.*—The proposed bill solves many of the problems imposed by REA when attempts are made to grant participant loans using vested interests as security. However, one problem left unsolved involves the participant who is unmarried at the time the loan is extended, but later becomes married. Loans made under this circumstance should receive the same protection as loans made before April 18, 1985.

(11) *Break in service rules—elapsed time plans.*—Guidance should be provided relative to application of break in service rules to plans using elapsed time concepts. This guidance could take the form of statutory provisions. Alternatively, it could take the form of Congressional instructions, to Treasury, to publish regulations on the subject promptly. At present, this subject does not appear to be as high on the regulatory priority list as it should be.

(12) *Broadening of gift tax exemption.*—In our discussion of DEFRA corrections, we raised objection to the repeal of § 2517. We believe one of the REA corrections should involve extension of the exemption of § 2517 to include a "gift" given by the participant's spouse who consents to an election away from spousal benefits.

(13) *Definition of accrued benefit.*—Attention should be given to the question of whether full subsidization of the qualified pre-retirement death benefit is part of the accrued benefit. For example, is full subsidization subject to the anti cutback rule?

For another example, suppose a vested terminator receives a lump sum settlement. Must the settlement include the value of the future pre-retirement spousal protection which would otherwise have been available? If so, must one consider the probability that a single employee will become married some time after employment termination?

It should be noted that depending on the answers to these questions, it may be necessary to amend definitions of actuarial equivalence to include marriage probabilities and marriage dissolution probabilities.

We suggest the position that full subsidization is not part of the accrued benefit for vesting and anti-cutback rules.

We would be eager to meet with members of the committees or their staffs to develop and clarify any of these recommendations.

STATEMENT OF HON. WILLIAM DONALD SCHAEFER, MAYOR OF THE CITY OF BALTIMORE, MD

Mr. Chairman and members of the Committee, I am pleased to submit my statement for the record with respect to your consideration of the Technical Corrections Act of 1985 (H.R. 1800). In particular, I wish to urge favorable consideration by the Committee for including a provision in the Technical Corrections Act of 1985 that will grant relief to the City of Baltimore and its taxpayers for the unexpected consequences of the enactment of Section 103(o) of the Internal Revenue Code of 1954 (the "Code") by the Deficit Reduction Act of 1984 ("1984 Tax Act"). This new provision of the Code has made it virtually impossible for the City to use the proceeds of general obligation bonds to be issued by the City to reimburse the City's Treasury for $27,000,000 in advances previously made to initiate certain activities previously approved by the voters for financing with the City's general obligation bonds.

By way of background, the City of Baltimore has made a general practice of marketing a single issue of general obligation bonds each year. The City is perhaps unique in this practice. From 1960 through 1981, these annual bond issues averaged slightly less than $35 million. From 1982 through 1985, in part because of adverse market conditions, the City's annual bond issues have averaged less than $20 million.

An essential component of the City's general obligation borrowing program in past years has been to allocate a portion of the money raised to encourage small businesses, minority undertakings, the renovation of decaying properties, the creation of employment opportunities, and the revitalization of neighborhoods. The City has used borrowed proceeds not only to provide for traditional public improvements, such as streets, schools, firehouses, utilities, parks, etc., but also in a deliberate and strategic manner to encourage private investment. For example, such encouragement in the form of a loan was necessary in the late 1970's to bring the Hyatt Regency Hotel to the Baltimore Inner Harbor. Today, that hotel enjoys the highest occupancy rate of any in the Hyatt chain and is a centerpiece of our spectacular Inner Harbor. In numerous other instances, the City has made loans or guaranteed loans for projects when banks and investors were either unwilling or unable to assume all of the risks. The renaissance of downtown Baltimore and the revitalization of Baltimore's neighborhoods have come about, in large part, because of the City's imaginative investment in public improvements and its financial participation in private investment enterprises with the proceeds of general obligation bond issues.

The activities supported by each issue of the City's general obligation bonds have in every instance been approved by the Maryland General Assembly, the Baltimore City Council, and the voters of Baltimore City in accordance with the requirements of the Maryland Constitution. Once the required legislative and voter approvals have been obtained, it has been the practice of the City, acting pursuant to authority in the City Charter, to advance money from the City's Treasury to initiate the approved activities, without waiting for the bond issue to be prepared and marketed. In every instance, we have expected that the Treasury would be fully reimbursed for these advances from the proceeds of the general obligation bonds. Many of the activities thus commenced with advances of City money meet the terms of Section 103(b)(2) of the Code defining industrial development bonds. However, under Section 103 of the Code and accompanying Treasury Regulations as they existed prior to the 1984 Tax Act, up to 25% of the proceeds of each annual issue of the City's general obligation bonds could be used to reimburse the Treasury for these advances. The City had no notice that this practice would not continue.

There is attached to my statement as Exhibit A a list of the activities commenced with the $27,000,000 in advances from the Treasury. Each of these projects involves the acquisition, construction or improvement of land and depreciable property and, in general, is of a type that could have been financed from the proceeds of tax-exempt industrial development bonds under the applicable provisions of the Code and implementing Treasury Regulations in effect at the time that such financings were undertaken, subject, of course, in the case of any particular project, to the need to comply with applicable limitations, such as the "$10,000,000 limit" for financings under Section 103(b)(6) of the Code and the "low or moderate income" requirements for financings of residential rental properties under Section 103(b)(4)(A) of the Code.

The City did not seek to finance these projects on a piecemeal basis through the issuance of tax-exempt industrial development bonds, first, because financing costs would have been greatly increased on a cumulative basis and would have been prohibitive in the case of many smaller loans, and second, because of the increased ad-

ministrative burdens and procedural complexities that would have been involved. In particular, substantial efforts would have been involved in selling the bonds on a competitive bid basis after giving appropriate public notice, as required by applicable law in the case of the sale of general obligation bonds, and in providing adequate disclosure to potential investors when bonds are offered in this manner. Further, until the Tax Equity and Fiscal Responsibility Act of 1982 was enacted in September, 1982, the City was effectively prohibited by Revenue Rulings 77-55 and 81-216 from aggregating the required borrowings for several projects into a single composite issue of industrial development bonds, a financing technique that would have lowered the cumulative issuance costs and lessened the administrative and procedural difficulties. In addition, having determined to finance these projects with the proceeds of the City's general obligation bonds as previously described, the City made commitments to various projects without in every case complying with certain procedural requirements applicable only to the issuance of tax-exempt industrial development bonds, such as obtaining "official action" before commencing construction and issuing bonds within one year of the date on which a project is placed in service.

The enactment of Section 103(o) by Section 626 of the 1984 Tax Act defined a new category of "consumer loan bonds", the interest on which is not exempt from taxation. To avoid becoming a consumer loan bond, no more that 5% of the proceeds of any issue of general obligation bonds issued after July 18, 1984 may be used for activities involving loans to non-exempt persons as defined by Section 103(b)(3). What this means for the City of Baltimore is that, for general obligations bonds issued after July 18, 1984, only 5% of the proceeds can be used to reimburse the Treasury for its prior advances.

Although we promptly ceased advancing funds from the Treasury for new activities once the implications of the new Section 103(o) were realized, enactment of Section 103(o) has nonetheless had a disruptive effect on the City's finances. The City has currently advanced from its Treasury $27,000,000 for activities that would fall within the definitions of Section 103(o)(2)(A). Full reimbursement of these funds was anticipated in good faith. If relief cannot be obtained through an amendment to the Technical Corrections Act of 1985, as I am requesting, these funds will have to be taken from other parts of the City's already hard-pressed budget and other City services may have to be curtailed.

In short, prior to the enactment of the 1984 Tax Act, the City's practice with respect to advancing funds from its Treasury to assure the prompt commencement of important developmental activities was both prudent and permissible. Yet now, because of enactment of Section 103(o) without any advance notice, the City is being forced to suffer a financial hardship.

I would like to emphasize that I am not seeking a permanent exemption from the requirements of Section 103(o). The City has and will continue to conform its practices to the new rules established by the 1984 Tax Act. All that I seek here is to obtain relief from the unexpected adverse impact of Section 103(o) on actions taken by the City in good faith prior to enactment of the 1984 Tax Act.

Language that would be suitable for inclusion in the Technical Corrections Act of 1985 is attached to my statement as Exhibit B.

I wish to thank the Committee for considering my request. Further information about my request can be obtained from my staff and, in particular, from David Falk in my Washington office (223-3020) and from James Vroonland in the City's Department of the Treasury (301/396-1924).

EXHIBIT A

City of Baltimore
Bond Authorization and Projects Awaiting Permanent Financing
Construction Financing Provided by Advance of City Funds

A. 10th Urban Renewal Ordinance $3,310,00

(1) Lexington Market Arcade $3,310,00

This project, an encouragement to private owners and merchants in the old Howard Street retail district, is owned by the City and leased to a non-profit corporation supported by the City. Stalls in the arcade are leased to a number of small for-profit vendors. Construction of the arcade began summer, 1981.

B. 2nd Industrial Financing Ordinance $5,040,000

These moneys have been used to make loans (or to guarantee loans) to various for-profit entities otherwise unable to obtain sufficient financing for their projects.

(1) Shake and Bake, $4,700,000, construction loans approved July 1, 1981 and October 6, 1982. This is a minority-sponsored neighborhood recreation center in west Baltimore. The sponsors were unable to find a lender for the project, and therefore the City made the construction loan.

(2) Norman Holt Florist, $110,000, construction loan approved April 19, 1981.
This small business venture was also assisted with a loan guarantee (see 4th Industrial Ordinance, below).

(3) Rockland Industries, $230,000, approved March, 1982. This textiles fabricator was forced to relocate from its Falls Road plant. This construction loan was part of a financing package (including an IDB and a loan guarantee by the City) which helped the company relocate its 200+ employees to a plant site within the City (see 4th Industrial Ordinance, below).

C. 3rd Industrial Financing Ordinance $1,095,000

(1) Belvedere Hotel, $1,000,000, approved July 15, 1981. This grand old building in the recently revitalized Mt. Vernon area (arts and culture center of the City) has undergone historic renovation and has been re-converted from apartment to hotel use (see also 4th Industrial Ordinance, below).

(2) Camp Manufacturing, $95,000, approved May 13, 1981. This company fabricates various school supplies. It used the City loan (along with an IDB) to expand its production facilities and employment (see also 4th Industrial Ordinance, below).

D. 4th Industrial Financing Ordinance $3,000,000

(1) Camp Manufacturing, $845,000, (see above)
(2) Belvedere Hotel, $2,000,000, (see above)
(3) Loan Guarantees $155,000

In addition to making direct loans, the City has found it necessary in some cases to guarantee all or a portion of loans made by banks or other parties. In such cases, the City normally places in escrow a 5% portion of the amount guaranteed. The guarantees in this instance are for loans made to Norman Holt Florist and Rockland Industries (both described above).

E. 1st Housing Development Ordinance $9,620,000

Moneys have been advanced to make construction loans or to guarantee loans made to developers of multi-family projects, in most instances to provide housing for low and moderate income families, and to undertake major renovations that have proven to be catalysts to neighborhood revitalization.

(1) Edmondale Apartments, $4,270,000, approved September 29, 1981 and September 29, 1982. Two hundred sixty-two low and moderate income units were rehabilitated with the City's construction loan. The project was delayed and the loan amount increased because of problems with contractor performance (see also 2nd Housing Ordinance, below).

(2) Battery Place, $5,350,000, approved August, 1981. Formerly the abandoned Southern High School, an eyesore inhibiting private investment in a residential neighborhood to the south of the Inner Harbor area. Conversion to market-rate apartments was financed originally with a guarantee of developer's construction loan. Developer was subsequently unable to pay on his loan, which required City performance under the guarantee.

F. 2nd Housing Development Ordinance $1,305,000

(1) Edmondale Apartments, $1,305,000, (described above)

G. 2nd Residential Financing Ordinance $140,000

(1) Pimlico Center-The International, $140,000, approved October 1978 thorugh March 1980. This former Holiday Inn in a blighted area in the northwest part of Baltimore, has been renovated and adapted in part to residential units.

H. 1st Commerical Financing Ordinance $3,488,000

4th Commerical Rehabilitation Ordinance $1,250,000

Construction financing has been advanced by the City under its Commercial REAL Loan program to make improvement loans to small businesses, many of them start-up operations, and thereby bring about physical improvements in neighborhood commercial areas.

The attached list shows loans closed 1980 through 1983.

Address	User	Use	Amount	Closing Date
1829-31 Pennsylvania Ave.	RUBIN & GREENEBAUM	retail	58000	3/28/80
4330-32;4400-04 York Rd.	KNEAVEL, William S.	retail	26860	2/26/82
3313 Greenmount Ave.	LEE, HYC, T: SUN HO CORP	restaurant	105000	1/4/80
3220 Greenmount Ave.	ADLER, Ira, Lucille	retail	67000	1/15/80
911 W. 36th Street	BREIGHNER, Bernard	retail	150000	9/19/80
2911 Greenmount Ave.	VACINO, Paul, Marcia	retail	33000	9/17/80
3431 Greenmount Ave.	BOWDEN, Susan D.	retail	17000	9/3/80
1603-05 St. Paul St.	LAMBERG, Standford, Lynne	offices	100000	2/27/81
100 E. 23rd Street	WOLFF, Harold, Ellen	offices	50000	8/27/81
153 N. Patterson Park Ave.	BEAVEN, Brian P.	restaurant	20000	2/26/82
210 E. Centre Street	JENKINS, Courntey; D.A.C.	health club	150000	2/11/82
5 Lloyd Street	MANDELL, JH, LL: BLUMBERG, KD	offices	25000	1/28/82
3203-8 Greenmount Ave.	MILLER REALTY: PRINCESS SHOPS	retail	75000	12/23/81
1020 S. Charles St.	HALLOWELL, John, Mary	retail/apts	50000	4/1/82
4341-45 York Road	INNER HARBOR LUMBER NORTH	ret/lmbr.	50000	2/16/82
4341-45 York Road	TREMPER, Theodore, Mary	retail	50000	2/26/82
Broadway Market	INT'L GROCERY; Mandatos	retail	27250	3/11/82
1708-20 Gorsuch Ave.	APPLEFELD, Michael	day care ctr.	65000	3/8/82
1413 S. Haven Street	SHAUGHNESSY, John, Mary	warehouse	60000	4/8/82
328 N. Charles St.	MCGINN, George	tavern	20000	7/26/82
809-18 W. 36th Street	SINGH, Jogendra	offices	25000	4/12/82
1633 E. Baltimore St.	WILLIAMS, Harry, Lorna	retail/home	55000	6/23/82
1600 S. Hanover St.	RASHED, Lotfy Sayed	vet office	45000	6/12/82
14 E. Preston St.	FULTON, James R.	office/apts	64800	7/1/82
4519 York Rd.	DRURY, JE: JED AUTOMOTIVE	retail	50000	6/29/82
1101 S. Howard St.	PRINCIPIO, Lou	tavern	60000	8/11/82
4500 York Rd.	WYBORSKI, J T, D	offices	26000	3/16/83
1443 Gorsuch Ave.	DURANS, Cliff; Research Assoc.	offices	48000	7/1/82
2127-29 W. Pratt St.	RISLEY, Bryan, Dorothy	mfg/retail	55000	8/18/82
4707-11 Liberty Hghts Ave.	NAM, Ki Young, Chi Dae	restaurant	45000	9/21/82
113 W. Franklin St.	SHANER, Thomas, Carol	offices	60000	12/23/82
825 E. Baltimore St.	LARKINS, Hayes, Eudora	office/apts	84000	11/18/82
200-02 W. Pratt Street	KATZENSTEIN, Stanley	retail	131500	12/21/82
3100 Elm Avenue	EDMEISTER, S; PRICE, S	studio/home	81000	3/24/83
828 E. Baltimore St.	WEBB, DALE, Synthia	offices	40000	6/16/83
4721-31 Liberty Hghts. Ave.	BINSKY, Ruth Wise	retail	118400	3/10/83
4625-27 Liberty Hghts. Ave.	CALVIN, Zisy Soudra	retail	12000	3/21/83
2301 N. Charles St.	BLG.CNGRES.EXCHNG.-Gus Robbins	offices	27000	5/22/82
1001 Hillen Street	LABOO, Roosevelt	offices	33445	8/26/83
2215 W. Forest Pk. Ave.	HUNT, PATRICIA-Dckyvl. Nursery	daycenter	12000	8/3/83

916 Light Street	SEWARD, Melvin, Delores	retail	75000	5/26/83
Lot 3, Holabird Ind Pk	COBUTTA ASSOC.	office/whse	61500	5/10/83
5217 York Road	HERRON, James & Barbara	offices	80000	7/14/83
400 E. Pratt Street	ORENDORFF, Greg. & POMPA, Vinct	restaurant	25000	10/28/83
824-26 E. Baltimore St.	BONNER, Wm., DAVIDSON, James	offices	180000	12/16/83
832 E. Baltimore St.	FEIT, BEN & SHIRL, IRV & RENEE	offices	70000	9/12/83
811 E. Baltimore St.	MEDAGLIA, Corneleus P.	office/rest	35000	7/25/80
4100 Pennington Ave.	GILDEN, Louis	retail	10000	10/18/83
4606 Garrison Blvd.	SCHULMAN, JALOWSKY	retail	21700	12/14/83
1737 Pennsylvania Ave.	FRANKLIN, Allan	retail	25200	10/21/83
2200 N. Howard St.	EZRINE, Chrl., BECKER, Larry	servicing	30000	11/17/83
515 W. Coldspring Lane	LEEB, Melvyn & Leslie	manuftrng	44000	12/28/83
805-07 E. Fayette St.	CRAEMER, Albert	restaurant	240000	2/26/80
422-24 W. Redwood St.	SILVERMAN, B, M; RAUSCHWALBE	retail/office	150000	3/14/80
1114-20 S. Charles St.	BROWN, SM, AR, A, P	retail	85000	10/6/80
814-20 N. Chester Street	NORTHEASTERN PLUMBING & HEAT	offices	60000	10/22/80
629 N. Duncan Street	CHERRY, Jack W.	retail	35300	1/19/81
823 W. Baltimore St.	SCHAEFER, RC, VA; Apollo	offices	87500	5/12/81
813 E. Baltimore St.	JOHNSON, Edward M.	offices	200000	4/10/81
3801 Fleet Street	KREBS FURNITURE; KREBS, LW, M	retail	50000	1/14/81
1401-09 S. Haven St.	WALHAUPTER, John	warehouse	32000	4/1/82
1620 Shakespeare St.	NORTON, Charles, Darcy	retail	63500	3/27/81
8 N. Howard St.	SANDLER, Bernard	hotel	200000	5/1/81
326 Park Avenue	FLORENDO, G, R	restaurant	68000	10/6/81
901-05 Fawn Street	SABATINO'S, INC.	restaurant	60000	7/27/81
322 N. Charles St.	SHAH, Arum, Maria	restaurant	110000	7/28/81
7 E. Franklin St.	ELLIS, David	offices	36000	10/21/81
2912 Oliver St.	OLIVER STREET PLAZA LTD.	retail	100000	12/12/81
1601-07 St. Paul Street	SEARS, JE; SMITH, BB	offices	55000	12/4/81
801 N. Charles St.	CHENG & ASSOCIATES	restaurant	100000	1/22/82
1309-11 N. Charles St.	BLOOM, Morris	tavern	42000	12/15/81
506-08 Pennsylvania Ave.	PLOTKIN, Gerald, Delores	retail	33600	7/6/80
1523 W. Baltimore St.	MINION, J, C; NEW IDEAS	retail/office	116400	1/18/80
204-08 W. Pratt St.	GOODMAN, Ellis	restaurant	250000	7/24/80

Address	User	Use	Amount	Closing Date
600 Washington Blvd.	STICK, Gordon, Jenniter	office/apts	97600	12/5/80
1036-40 Patapsco St.	STREUVER, FSS, NS NB	retail	30000	1/7/81
1210-12 Bayard St.	KORZEC, George, Anneliese	retail	55000	11/17/80
835 W. Lombard St.	NEKULSKI; SCHIAVONE	retail/office	50000	2/17/81
1399 Ramsey St.	SHOWALTER, M; MUELLER, W, F	mfg/retail	8000	6/16/81
29-31 W. North Ave.	PAK, Housural, Kyuryon	offices	70000	10/15/81
1831 Pennsylvania Ave.	RUBIN, STONE GREENBAUM	retail	58000	3/28/80
3601 Park Hgts. Ave.	ROBINSON, Clifford, Pettis	retail	60000	7/13/80
1605-07 Sulgrave Ave.	KLEIN, Stanly, Esther	retail	24350	6/16/80
3401½ Clifton Ave.	FELDMAN, Samuel	retail	37100	10/29/80
5726 Falls Rd.	LEEB, Melvyn, Leslie	mfg/office	17000	10/6/81
1600-02 W. Baltimore St.	FINCHAM, Victor	tavern	16600	10/6/81
4713-35 Gwynn Oak Ave.	FELDMAN, Samuel, Fannie	retail	32000	1/22/82
5460 Park Hgts. Ave.	KWON, Jong, Me Hwa	retail	50000	3/27/81

FXHIBIT B

PROPOSED NEW SUBSECTION (a)(4) OF SECTION 166
OF TECHNICAL CORRECTIONS ACT OF 1985
(H.R. 1800)

(4) by adding a new subsection (4) as follows:

(4) CERTAIN GENERAL OBLIGATION BONDS ISSUED BY MAYOR AND CITY COUNCIL OF BALITMORE. No obligations of the Mayor and City Council of Baltimore issued after June 30, 1985 which are not industrial development bonds (within the meaning of subsection (b)(2)) shall be treated as private loan bonds on account of the use of a portion of the proceeds of such obligations to finance or refinance temporary advances made by the City of Baltimore in connection with loans to persons who are not exempt persons (within the meaning of subsection (b)(3) if (i) the portion of the proceeds of such obligations so used is attributable to debt approved by voter referendum on or before November 2, 1982, (ii) the loans to such non-exempt persons were approved by the Board of Estimates of the City of Baltimore on or before October 19, 1983, and (iii) the aggregate amount of such temporary advances financed or refinanced by such obligations does not exceed $27,000,000.

STATEMENT OF BENEFICIAL CORP.

PROPOSED AMENDMENT OF SECTION 110(d) OF THE TECHNICAL CORRECTIONS BILL OF 1985

Section 110(d) of the Technical Corrections Bill of 1985 sets forth proposed amendments to section 127 of the Tax Reform Act of 1984, including one amendment specifically to section 127(g). For the reasons discussed below, an additional technical correction needs to be made in section 127(g).

1. *General.*—Section 127(g) of the Tax Reform Act of 1984 provides, in effect, that interest payments by a U.S. affiliate to a Netherlands Antilles finance subsidiary on obligations issued before June 22, 1984 should not be subject to U.S. withholding tax. Even though section 127(g) refers only to interest received by a Netherlands Antilles finance subsidiary and does not refer to borrowings by a Netherlands Antilles finance subsidiary, it is clear that the basic intent of section 127(g) is to cover interest payments received by a finance subsidiary from a U.S. affiliate in those situations where the U.S. affiliate's obligation is attributable to an outstanding borrowing of a finance subsidiary made prior to June 22, 1984. The Joint Committee staff's published interpretation of section 127(g) evidences this intent. Although section 127(g) itself refers only to obligations issued before June 22, 1984, according to the Joint Committee's explanation section 127(g) covers rollovers of pre-June 22, 1984 obligations and new obligations which are substituted for pre-June 22, 1984 obligations "as long as the total amount of U.S. affiliate obligations is not increased by the foregoing and so long as the applicable CFC does not acquire new funds after June 22, 1984." General Explanation of the Revenue Provisions of the Tax Reform Act of 1984, Staff of the Joint Committee on Taxation, p. 397. See also section 121(b) of the Tax Reform Act of 1984 which contains a related grandfather provision which is tied to outstanding borrowings of a finance subsidiary.

2. *Technical problems.*—Unfortunately, section 127(g) is technically too restrictive to accomplish its apparent objective. The basic problem arises out of the fact that some Antilles finance subsidiaries sometimes borrowed long from unrelated parties and lent short to affiliates with the result that they may benefit from the section 127(g) grandfather provision only if the "rollover" protection referred to above is available. For instance, finance subsidiaries may have issued long-term eurodollar debt in 1980 that was due and payable in 1990. However, the subsidiary may have been lending the proceeds of this debt issue to U.S. affiliates on a short-term basis, such as 6 months. These short-term loans would have to be rolled over or renewed every 6 months. However, interest paid on those rolled over loans may not qualify for the rollover protection referred to above because of the occurrence of events beyond the control of the companies involved.

For example, prior to 1984, Antilles finance subsidiaries of a number of companies, including Beneficial, issued warrants entitling the holders thereof to purchase debt obligations of the finance subsidiary subsequent to June 22, 1984. In some instances, these warrants have been exercised since June 22, 1984 with the result that the finance subsidiary has acquired new funds since June 22, 1984. The above quoted statement of the Joint Committee staff explanation that section 127(g) will not apply to a rollover of a pre-June 22, 1984 obligation if the finance subsidiary acquires new funds after that date suggests that the finance subsidiary's acquisition of new funds due to the exercise of its warrants will make the section 127(g) grandfather provision inapplicable to the rollover of any short-term affiliate obligation. Thus, section 127(g) may be inapplicable to a short-term affiliate obligation that is in fact attributable to a borrowing of the finance subsidiary which was made prior to June 22, 1984 and which is still outstanding. Such a result would be both illogical and inequitable.

Another situation which would be beyond the control of a finance subsidiary arises where a finance subsidiary issued long-term zero coupon obligations prior to June 22, 1984 and lent the proceeds thereof to U.S. affiliates in exchange for interest bearing obligations. In order to accumulate the funds needed to pay the zero coupon obligation at maturity, the finance subsidiary needs to reinvest the interest it receives on its interest bearing loans to the U.S. affiliates. In normal course, this interest would be reinvested by simply lending it back to the U.S. affiliates, but the section 127(g) grandfather provision arguably does not cover such a loan.

Another potential problem relates to the reference in the Joint Committee staff explanation to the acquisition of "new funds." Although, this reference was probably intended to refer to the acquisition of new funds as a result of a borrowing, it, unfortunately, is not limited to borrowings. The reference therefore raises a question whether the receipt of funds by a finance subsidiary from activities other than lending will make the section 127(g) grandfather provision inapplicable to any roll-

over. For example, would the receipt by a finance subsidiary of a fee from a forward currency contract entered into by the subsidiary after June 22, 1984, make the rollover relief unavailable?

3. *Proposal.*—In order to correct the above-stated ambiguities or deficiencies in section 127(g), it should be amended to include a provision similar to the grandfather provision contained in section 121(b) of the Tax Reform Act of 1984 which basically is tied to prior outside borrowings made by a finance subsidiary. Section 121(b) is designed to cover interest received or accrued prior to 1992 on U.S. affiliate obligations held by a finance subsidiary which is an applicable CFC, but only if the interest is received or accrued on U.S. affiliate obligations that are attributable to the finance subsidiary's capitalization (certain outside borrowings and equity) on March 31, 1984. Thus, if section 121(b) were added to section 127(g), this addition would cover only interest attributable to certain activities of a finance subsidiary prior to the Tax Reform Act of 1984.

It is relatively easy to provide for such grandfathering by amending section 127(g) of the Tax Reform Act of 1984 to provide that it also covers the payment of "qualified interest" as that term was defined in section 121(b) of the Tax Reform Act of 1984. Attached hereto as attachment A is a draft of such an amendment to section 127(g). The references to June 21, 1984 are intended to be consistent with the fact that section 127(g) originally applied to interest paid on obligations issued before June 22, 1984.

In addition, in order to make it unambiguously clear that the proposed amendment covers interest received on the reinvestments referred to in the zero coupon obligation situation discussed above, there should be included in the legislative history to the Technical Corrections Bill a paragraph that now appears (at p. 353) in the Joint Committee Staff's explanation of section 121(b) of the Tax Reform Act of 1984, together with an example. A copy of this paragraph together with the suggested example is attached hereto as attachment B. The parenthetical language in the example is intended to make it clear that the numerator of the applicable fraction is to be adjusted if the proceeds of an OID-type CFC obligation were used to finance U.S. affiliate obligations even if the U.S. affiliate obligations were interest bearing obligations which had no OID.

4. *Technical corrections bill of 1985.*—The Technical Corrections Bill of 1985, as introduced in the House and the Senate, proposes to liberalize section 127(g) in two respects. One liberalization involves extending the section 127(g) grandfather provision to cover not only interest payments to a U.S.-owned Netherlands Antilles finance subsidiary but also interest payments to a foreign-owned Netherlands Antilles finance subsidiary. This liberalization is considerably more expansive than the technical correction proposed herein and it constitutes an acknowledgment that section 127(g) warrants additional refinement.

ATTACHMENT A

Act Sec. 127(g) provides:

(3) SPECIAL RULE FOR CERTAIN UNITED STATES AFFILIATE OBLIGATIONS.—

(A) IN GENERAL.—For purposes of the Internal Revenue Code of 1954, payments of qualified interest or interest on a United States affiliate obligation to an applicable CFC in existence on or before June 22, 1984, shall be treated as payments to a resident of the country in which the applicable CFC is incorporated.

(B) EXCEPTION.—Subparagraph (A) shall not apply to any applicable CFC which did not meet requirements which are based on the principles set forth in Revenue Rulings 69-501, 69-377, 70-645, and 73-110.

(C) DEFINITIONS.—

(i) The term "applicable CFC" has the meaning given such term by section 121(b)(2)(D) of this Act, except that such section shall be applied by substituting "the date of interest payment" for "March 31, 1984," in clause (i) thereof.

(ii) The term "United States affiliate obligation" means an obligation described in section 121(b)(2)(F) of this Act which was issued before June 22, 1984.

(iii) The term "qualified interest" has the meaning given such term by section 121(b)(2)(B) of the Tax Reform Act of 1984, except that such section shall be applied by substituting "June 21, 1984" for "March 31, 1984" in subparagraphs (B), (C), (D) and (I) of section 121(b)(2) and by omitting the references in sections 121(b)(2)(C)(i)(I) and 121(b)(2)(I)(ii) to obligations issued before March 8, 1984 and after March 7, 1987.

ATTACHMENT B

For purposes of this transitional rule, the principal amount of CFC and U.S. affiliate obligations with OID includes, as of any day, the aggregate amount of all OID on such obligations previously includible in gross income as of that day. Proper adjustments are to be made in the numerator of the limiting fraction for OID accruing after June 21, 1984 on CFC obligations and U.S. affiliate obligations. The latter rule allows an upward adjustment in the numerator, where necessary, for OID accrued after June 21, 1984 on OID-type CFC obligations. However, to the extent that the proceeds of OID-type CFC obligations included in a CFC's June 21, 1984 capitalization were used, as of June 21, 1984, to finance non-U.S. affiliate obligations, no special adjustment in the numerator will be allowed under this rule. For example, if one-half of the proceeds of such obligations were used as of June 21, 1984, to finance U.S. affiliate obligations (whether with or without OID), then an adjustment shall be made in the numerator only with respect to one-half of the OID accruing after June 21, 1984 on such obligations.

STATEMENT OF LOUIS W. CABOT, CHAIRMAN OF THE BOARD, AND WALTER W. GREELEY, GENERAL COUNSEL, SECRETARY, AND VICE PRESIDENT, CABOT CORP.

This statement is submitted on behalf of Cabot Corporation, a United States producer of carbon black. Carbon black is elemental carbon with some incidental or planned surface oxidation, that is formed under the controlled cracking, heating and cooling of a petroleum derivative feedstock. It is chiefly used by the rubber industry where it is indispensable as a strength reinforcing agent, wear-resistance agent, a filler, coloring agent, and anti-weathering agent. Cabot Corporation is the world's largest producer of carbon black.

The purpose of this submission is to request that a clarifying or technical amendment be made to section 611 of the Trade and Tariff Act of 1984 (or to section 303(a)(2) of the Tariff Act of 1930, as amended) to eliminate the possibility of any confusion in the administration of our countervailing duty law when a non-GATT member becomes a "country under the Agreement" within the meaning of section 701 of the Tariff Act of 1930.

A clarifying amendment would eliminate the possibility of any controversy over the recently signed U.S.-Mexico agreement and over any future agreements involving other non-GATT signatories. Cabot has a strong interest in such a technical amendment. As described below, Cabot has been attempting for the last three years to obtain meaningful relief from the Mexican subsidiary practices on carbon black (there is presently outstanding a countervailing duty order covering carbon black from Mexico). Certain Mexican industries have sought to void outstanding countervailing duty orders through a fairly tortured interpretation of current law. Cabot's proposal would make certain that the law could not be misinterpreted to require automatic revocation of outstanding countervailing duty orders.

1. Cabot Corporation's efforts to obtain relief from imports of Mexican carbon black under our countervailing duty law.

Through late 1981 and most of 1982, Cabot found itself undercut in the market place by increasing imports of subsidized carbon black from Mexico. On November 3, 1982, Cabot sought to avail itself of the protections afforded domestic producers under U.S. law against such unfair trade practices, by filing a countervailing duty petition with the Department of Commerce ("ITA") under § 303.

Since Mexico was not a "country under the agreement" within the meaning of § 701(b) of the Act, and no "international obligations" within the meaning of § 303(a)(2) of the Act required an injury determination for non-dutiable merchandise from Mexico, there was no injury investigation by the U.S. International Trade Commission ("ITC"). See *Carbon Black from Mexico*, 48 Fed. Reg. 29,564 (1983). On June 27, 1983, more than seven months after the filing of Cabot's petition, the ITA published a final affirmative countervailing duty determination and countervailing duty order for carbon black from Mexico. Id. The ITA's determination confirmed Cabot's allegations that the Mexican carbon black producers were being provided benefits which constitute bounties or grants within the meaning of the countervailing duty law, and imposed a duty on imports of Mexican carbon black intended to offset that benefit.[1] Id.

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[1] Cabot has challenged certain aspects of the ITA's final determination (particularly the provision of carbon black feedstock, which accounts for about 60 percent of total cost of producing

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Since the ITA's affirmative determination, Cabot Corporation has continued to actively participate in the ITA's ongoing administrative review of that determination under § 751 of the Act. Despite the outstanding countervailing duty order issued in June, 1983, imports of carbon black from Mexico, as reported by the Commerce Department, increased by almost 280% between 1982 and 1983, from 6.7 million pounds to nearly 19 million pounds and more than doubled again in 1984 to almost 50 million pounds. Imports from Mexico in 1985 are similarly running at nearly twice the rate of the like period in 1984.

It is against this background of massive increases in Mexican carbon black exports to the United States despite the presence of a countervailing duty order that the allegation by certain Mexican respondents that immediate revocation of countervailing duty orders on Mexican products should be measured.

2. The request for immediate revocation and its relevancy to Cabot.

On April 23, 1985, the U.S. and Mexico entered into an agreement in which Mexico agreed to eliminate over time certain of its subsidy practices and the United States agreed to require that injury to a U.S. industry be demonstrated prior to the imposition of countervailing duties on Mexican products exported to the United States. As a result of this agreement, Mexico was officially designated a "country under the agreement" in accordance with the provisions of § 2(b) of the Trade Agreements Act of 1979, and § 701(b) of the Act, by the U.S. Trade Representative effective April 23, 1985. See *Determination Regarding the Application of Certain International Agreements,* 50 Fed. Reg. 18,335 (1985).

This agreement on its face does not require an injury determination with respect to outstanding countervailing duty orders. Nevertheless, shortly after it was signed, respondents in the countervailing duty investigation of fabricated automotive glass from Mexico, a duty-free product, requested that the ITA revoke that countervailing duty order. Letter of April 26, 1985 from I. Altschuler to Secretary of Commerce ("Letter Requesting Revocation"). These producers asserted that the ITA must immediately revoke the outstanding countervailing duty order because "the U.S. government no longer has authority to impose countervailing duties upon importation of fabricated automotive glass from Mexico under the existing countervailing duty order, which was issued under Sec. 303." Letter Requesting Revocation at 3.

These Mexican producers base their request for revocation on their reading of § 303(a)(2) of the Act in tandem with the U.S./Mexican agreement. In addition, however, they claim that the ITA is bound to grant their request by its own precedent in partially revoking the countervailing duty order with respect to fasteners from India.

Like fabricated automotive glass from Mexico, imports of carbon black from Mexico enter the United States today and at the time of the investigation duty-free. However, in both cases, at the time of the investigation Mexico was not a "country under the Agreement" and was not a signatory to the GATT. Accordingly, cases were brought under section 303, and no injury test was required under 19 U.S.C. 1303(a)(2). *E.g.,* 50 Fed. Reg. 1,906 at 1,907 (1985). Similarly, in both cases, the countervailing duty order was issued prior to the U.S./Mexican Agreement.

As is apparent from the above brief discussion, if the revocation request for automotive glass from Mexico were granted, it would establish a precedent that would be difficult, if not impossible, for Cabot and other domestic petitioners in cases involving duty-free merchandise from Mexico to distinguish in any challenge to an outstanding countervailing duty order.

3. The revocation request by the Mexican producers is contrary to the intent underlying both the U.S./Mexican agreement and § 303(a)(2) of the act.

Section 303(a)(2) of the Act, which is at the center of the Mexican producers' request for revocation, provides as follows: In the case of any imported article or merchandise which is free of duty, duties may be imposed under this section only if there are affirmative determinations by the Commission under subtitle IV of this chapter; except that such a determination shall not be required unless a determination of injury is required by the international obligations of the United States. 19 U.S.C. § 1303(a)(2). This provision provides that an injury test is a prerequisite for the application of countervailing duties to non-dutiable goods, but only if the international obligations of the United States so require. The Mexican producers claim that as a result of the U.S./Mexican Agreement such an international obligation now exists making that provision applicable to duty-free articles from Mexico. In

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carbon black, at prices as little as ⅓oth the price available on the world market) which it believes improperly resulted in a substantial underestimation by the agency of the actual net bounties or grants received by the Mexican producers. See *Cabot Corporation* v. *United States,* CIT Consol. Court No. 83-7-01044.

addition, they claim that § 303(a)(2) of the Act not only prohibits the imposition of countervailing duties through new duty orders absent an injury determination, but also retroactively prohibits the assessment of countervailing duties on duty-free merchandise pursuant to outstanding countervailing duty orders unless an injury test has been conducted by the ITC. As discussed below, both of these arguments are specious and would lead to absurd results not intended by Congress.

The sole source of an international obligation of the United States to provide imports from Mexico an injury test is the bilateral agreement between the United States and Mexico previously referenced.[2] That agreement did not, however, establish an international obligation to provide an injury test for merchandise, duty-free vel non, already subject to a countervailing duty order. It contains no special provisions with respect to duty-free or GSP products, and the only injury test requirement under the agreement is clearly prospective in application. Article 5 of the Agreement, which sets forth the injury requirement, states as follows: "For purposes of the application of countervailing measures, there shall be no presumption that incentives granted by the Government of the United Mexican States result in adverse effects to the trade or production of the United States. Such adverse effects shall be demonstrated by positive evidence, through formal investigation procedures prescribed by applicable U.S. domestic law for determining the economic impact of Mexican imports upon an industry in the United States. *With respect to all United States countervailing duty investigations in progress concerning products of Mexico as of the date of entry into force of this Understanding,* the United States shall ensure that no countervailing duties shall be imposed upon any product of Mexico unless it is determined that the subsidized imports are, through the effects of the subsidy, causing or threatening to cause material injury to an established domestic industry, or retard materially the establishment of a domestic industry. [Emphasis added.]

The only reasonable conclusion of the above quoted language, when read in conjunction with the relevant language of the Tariff Act of 1930, as amended, is that the injury test is prospective in application only. The term "investigation" has a well established meaning under the countervailing duty law; it is defined in the ITA's regulations at 19 C.F.R. § 355.6(b) as "that time between the publication of a notice of initiation and the publication of the earliest of (1) a notice of termination, (2) a negative determination that has the effect of terminating the administrative proceedings; or (3) an Order." Accord S. Rep. No. 249, 96th Congress, 1st Sess. 46 (1979). Consequently, the injury test required under the U.S./Mexican agreement was not intended to apply to outstanding countervailing duty orders since they are issued only after completion of the ITA's investigation.[3] Thus, because the countervailing duty investigations of products such as fabricated automotive glass and carbon black from Mexico have been completed, the prospective injury test under Article 5 of the United States-Mexico agreement does not apply to those orders. There is, therefore, no international obligation within the meaning of § 303(a)(2) requiring an injury test with respect to outstanding countervailing duty orders. Thus, § 303(a)(2) has no application to outstanding countervailing duty orders from Mexico.[4]

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[2] Prior to the conclusion of that agreement, there was *no* requirement that injury be proven before a countervailing duty could be imposed on imports of duty-free goods from Mexico. See, e.g., "Toy Balloons (Including Punchballs) and Playballs from Mexico," 47 Fed. Reg. 57,532 (1982). Therefore, the extent of an obligation on the part of the United States to provide an injury test to nondutiable imports from Mexico is determined by the provisions of the United States-Mexico agreement.

[3] Even if the text of the U.S./Mexican agreement did not specifically preclude retroactive application of the injury test, in the absence of some specific indication that the agreement was intended to have retroactive effect, under established rules of statutory interpretation (logically equally applicable to the U.S./Mexican Agreement which establishes legal obligations), such a limitation would necessarily have to be implied. See *Ex parte McCardle*, 74 U.S. 506 (1868) (where a law specifies those situations to which it is applicable, it is presumed that all situations not specified are excluded). See, also, *Brewster* v. *Gage*, 280 U.S. 327, 337 (1929) (laws are not to be assumed to have retroactive effect, unless that purpose plainly appears).

In addition, the Mexican producers' interpretation of the agreement would require Congress to have intended the ITA squander valuable resources on a full reinvestigation of outstanding countervailing duty orders although that agreement specified that a less burdensome injury determination would suffice with respect to investigations in progress.

[4] This interpretation of the injury test in the U.S./Mexican Agreement as having prospective application only would be consistent with rights granted in similar bilateral agreements. For instance, in the recently concluded free-trade agreement with Israel, under which each country agreed to remove progressively all tariffs on the other's products, the injury test was likewise

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Even assuming arguendo that an international obligation within the meaning of § 303(a)(2) of the Act did exist, § 303(a)(2) was not intended to and does not provide a basis for the revocation of outstanding duty orders. Any other interpretation would be inconsistent with the overall statutory scheme of the countervailing duty law and the changes thereto made in 1979.

For example, section 102 of 1979 Act, 19 U.S.C. § 1671 (note) specifically provides for the termination of an ongoing countervailing duty investigation under § 303 and reinstitution of the investigation under § 701 of the Act, where the provisions of title VII become effective with respect to the subject country prior to a final determination under § 303. See, e.g., *Lamb Meat from New Zealand,* 46 Fed. Reg. 47,106 (1981); *Converted Paper-Related School and Office Supplies from Mexico,* 50 Fed. Reg. 20,117 (1985). If a country becomes a country under the Agreement after a final determination has been made under § 303, there is no requirement under § 102 that the investigation be recommenced under § 701. The language of § 102 does not differentiate between investigations completed under § 303(a)(2) and those under § 303(a)(1); it refers only to an investigation under "section 303." The argument of the Mexican producers, however, requires such a differentiation by providing that investigations under § 303(a)(2), but not under § 303(a)(1), must be reopened, and an injury test applied.

Moreover, respondent's interpretation of § 303(a)(2) would illogically require an injury test of the ITC which that agency is unable to provide. Where Congress intended to provide for an injury test by the ITC, it knew how to do so. Nowhere did Congress authorize the ITC to conduct an injury investigation with respect to outstanding countervailing duty orders originally issued without an injury determination under § 303 of the Act after January 1, 1980. Thus, in § 104(b) of the Trade Agreements Act of 1979, Congress provided the ITC authority to review a determination under § 303 of the Act if that determination was in effect on January 1, 1980, and if a request for ITC review was filed by January 1, 1983. Similarly, the ITC has determined that § 751(b) only authorizes an injury review with respect to prior injury determinations of the Commission under § 701 of the Act, see Letter of February 11, 1985, from Chairwoman Stern, ITC, to Alan Holmer, Deputy Assistant Secretary for Import Administration, ITA.

Most absurd in the Mexican auto glass producers' position is the alleged requirement that countervailing duty orders be revoked immediately upon a country's becoming a "country under the agreement". Contrary to legislative intent, such an interpretation of § 303(a)(2) would *reward* countries for failing to accede to the subsidies code promptly] For example, in Cabot's case, while a countervailing duty order has been in place for nearly two years (published June 27, 1983), there has been no assessment of countervailing duties on imported Mexican carbon black to date. While a section 751 review has been underway for some time, under the theory advanced by the Mexican respondents, the review would not be completed, no countervailing duties would be assessed and all estimated duties paid by U.S. importers would be refunded. Thus, more than two and a half years after the initiation of a countervailing duty case, the domestic industry producing carbon black will have received no relief despite strict compliance with all applicable regulations, despite a determination of countervailable benefits being given to the Mexican competitors and despite no demonstration of any kind that the domestic industry would not be harmed by the removal of the countervailing duty order. By failing to agree to bring itself into compliance with the subsidies code for more than five years, Mexico would have the Congress and Executive Branch believe that it can escape the neutralizing effects of U.S. countervailing duties while its subsidized exports have surged exponentially into the U.S. market] [For example, imports of carbon black from Mexico have doubled or more every year in the recent past and may reach 100 million pounds in 1985—up from less than 7 million pounds in 1982.] To state the proposition is to demonstrate its absurdity.

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intended for prospective application only. *See* Provisional Transcript of Hearings before the Committee on Ways and Means, United States House of Representatives, on the Proposed U.S.-Israel Free Trade Area Agreement, March 6, 1985, at 92-93 (statement of Rep. Frenzel (R. Minn.)) ("I thought we were [being] prospective [in applying the injury test] and we were protecting previous arrangements. . . ."); H.R. Rep. No. 64, 99th Cong., 1st Sess. 8 (1985) ("The test will be applied prospectively, not to existing countervailing duty orders.") (attached as Exhibit 2). See, also, Testimony on behalf of Roses, Inc. before the Committee on Finance, United States Senate, on the Proposed U.S.-Israel Free Trade Area Agreement, March 6, 1985 at 4 (attached as Exhibit 3). The question of retroactive application of the test to non-dutiable articles did not arise in the context of the U.S./Israeli Agreement, since Israel was already a member of the GATT and thus entitled to an injury test on such goods prior to the agreement.

As this Committee is well aware, a major goal of the 1979 Act was to encourage foreign countries to become countries under the Agreement promptly to avoid countervailing duty orders where injury need not be shown. See S. Rep. No. 249, 96th Cong., 1st Sess. 45–47 (1979). Yet, for countries which promptly became signatories to the Subsidies Code, there was no retroactive revocation of countervailing duty liability. Thus, delay would be rewarded and compliance with international commitments penalized.

4. There is no Commerce Department precedent which requires revocation.

The only other "support" for the revocation request is the alleged "precedent" in the Commerce Department decision to revoke the countervailing duty order with respect to fasteners from India. Letter Requesting Revocation at 3. However, the factual and legal principles used by the ITA in Certain Fasteners from India, 47 Fed. Reg. 44,129 (1982) [and in a similar preliminary determination by the ITA to revoke the order outstanding against *Carbon Steel Wire Rod from Trinidad and Tobago,* 50 Fed. Reg. 19,561 (1985)], are not present in this case.

On July 21, 1980, a countervailing duty order was issued by the ITA on certain fasteners from India. 45 Fed. Reg. 48,607. Although India was a signatory to the GATT, it was not a signatory to the Subsidies Code prior to the issuance of the countervailing duty order in mid 1980. Accordingly, the countervailing duty investigation was carried out and an order was issued under § 303 of the Act. The United States did not officially recognize India as a country under the Agreement until September, 1981. See 47 Fed. Reg. 29,695 (1982) (Notice of intent to review the countervailing duty order).

As the fasteners from India were subjected to a temporary duty at the time of the original investigation (resulting from escape clause relief), no injury test was required under section 303. On January 6, 1982, certain of the fasteners covered by the outstanding countervailing duty order again became eligible for duty-free treatment. As India was a signatory to the GATT and now recognized as a signatory to the GATT Agreement on Subsidies and Countervailing Measures, the Government of India requested the ITC to conduct an injury investigation in accordance with § 303(a)(2). After the ITC informed the ITA that it was without authority to conduct the requested injury determination, the ITA determined that under § 303(a)(2), in view of the outstanding international obligations of the U.S. with respect to full-GATT signatories such as India, it was required to partially revoke its determination with respect to fasteners from India. The ITA's determination stated as follows: "By statute, the Department is authorized to impose countervailing duties on duty-free products *from GATT member countries* only if the International Trade Commission has found that imports of the merchandise materially injure, or threaten to materially injure, a United States industry. There has been no such determination with respect to duty-free fasteners from India covered by this order. As a result, the Department is revoking the countervailing duty order on certain fasteners from India with regard to covered duty-free fasteners." 47 Fed. Reg. at 44,129 (1982) [Emphasis added.]

Mexico is, of course, not a signatory to the GATT. Thus, the limitation of the GATT "grandfather clause" for U.S. countervailing duty actions is not relevant. S. Rep. No. 1298, 93d Cong., 2d Sess. 185 (1974); S. Rep. No. 249, 96th Cong., 1st Sess. 103 ("[t]he United States is obligated to apply the injury test under section 303 only with respect to duty-free products of countries which have fully acceded to the General Agreement on Tariffs and Trade.").

Moreover, at the time of the original investigation on products such as carbon black, the imports entered duty free from Mexico. As there were no international obligations with respect to Mexico requiring an injury test on duty-free merchandise, no injury test was warranted or provided.

The same basis of the ITA's determination to revoke in *Certain Fasteners from India* was used by the agency in its recent tentative determination to revoke in *Carbon Steel Wire Rod from Trinidad and Tobago.* Since the basis for the ITA's determination in *Fasteners from India* and *Wire Rod from Trinidad an Tobago* is not present in the instant case, those determinations have no precedential effect with respect to the instant case.

5. A clarifying technical amendment either to the Trade and Tariff Act of 1984, or to the Tariff Act of 1930, can eliminate any possibility of domestic industries being adversely impacted by an unwarranted statutory interpretation.

The foregoing discussion demonstrates the absurdity of the allegations raised by certain Mexican respondents about the scope of section 303(a)(2) of the Act and the recent U.S.-Mexican agreement. However, because the harm to a domestic industry would be so draconian (loss of the countervailing duty order, liquidation of all entries potentially subject to countervailing duty liability, cost to prepare and file a

new countervailing duty action) if the proposed interpretation were ever adopted by the Executive Branch, Cabot believes it appropriate for Congress to remove any possible doubt as to the statutory meaning of section 303(a)(2). Such a result could be achieved through a technical amendment to section 611 of the Trade and Tariff Act of 1984 (an Act specifically included within the coverage of H.R. 1800) or through an amendment to section 303(a)(2) directly. Various proposed optional language is attached for the Committee's consideration.

POSSIBLE STATUTORY CHANGES

Suggested changes in existing law are shown as italicized.

Option No. 1

Amendment to § 303(a)(2) of the Tariff Act of 1930, as amended ("the Act"), 19 U.S.C. § 1303(a)(2):

(2) In the case of any imported article or merchandise which is free of duty, duties may be imposed under this section only if there are affirmative determinations by the Commission under subtitle IV of this chapter; except that such a determination shall not be required *retroactively and shall not be required* unless a determination of injury is required by the international obligations of the United States.

Option No. 2

Amendment to § 303(a)(2) of the Act, 19 U.S.C. § 1303(a)(2):

(2) In the case of any imported article or merchandise which is free of duty, duties may be imposed under this section only if there are affirmative determinations by the Commission under subtitle IV of this chapter; except that such a determination shall not be required unless a determination of injury is required by the international obligations of the United States *existing prior to publication of the countervailing duty order imposing duties on that imported article or merchandise.*

Option No. 3

Amendment to § 303(a)(2) of the Act, 19 U.S.C. § 1303(a)(2):

(2) In the case of any imported article or merchandise which is free of duty, duties may be imposed under this section only if there are affirmative determinations by the Commission under subtitle IV of this chapter; except that such a determination shall not be required *with respect to existing countervailing duty orders* unless a determination of injury *with respect to such outstanding orders is specifically* required by the international obligations of the United States.

Option No. 4

Amendment to § 751(a)(1) of the Act, 19 U.S.C. § 1675(a)(1), (technical amendment to § 611(a)(2)(A) of the Tariff and Trade Act of 1984):

(a) PERIODIC REVIEW OF AMOUNT OF DUTY.—

(1) IN GENERAL.—At least once during each 12-month period beginning on the anniversary of the date of publication of a countervailing duty order under this title or under section 303 of this Act, an antidumping duty order under this title or a finding under the Antidumping Act, 1921, or a notice of the suspension of an investigation, the administering authority, if a request for such a review has been received and after publication of notice of such review in the Federal Register, shall—

(A) review and determine the amount of any net subsidy,

(B) review, and determine (in accordance with paragraph (2)), the amount of any antidumping duty, and

(C) review the current status of, and compliance with, any agreement by reason of which an investigation was suspended, and review the amount of any net subsidy or margin of sales at less than fair value involved in the agreement,

and shall publish the results of such review, together with notice of any duty to be assessed, estimated duty to be deposited, or investigation to be resumed in the Federal Register. *The administering authority shall not review a countervailing duty order or determination issued under* § 303 of this Act except under this subsection.

Option No. 5

Amendment to § 751(b)(1) of the Act, 19 U.S.C. § 1675(b)(1), (technical amendment to § 611(a)(2)(B) of the Tariff and Trade Act of 1984):

(b) REVIEWS UPON INFORMATION OR REQUEST.—

(1) IN GENERAL.—Whenever the administering authority or the Commission receives information concerning, or a request for the review of, an agreement accepted under section 704 (other than a quantitative restriction agreement described in subsection (a)(2) or (c)(3)) or 734 (other than a quantitative restriction agreement described in subsection (a)(2)) or an affirmative determination made under section 704(h)(2), 705(a), 705(b), 734(h)(2), 735(a), 735(b), 762(a)(1), or 762(a)(2), *but not an affirmative determination or order under* § 303 of this Act, which shows changed circumstances sufficient to warrant a review of such determinations, it shall conduct such a review after publishing notice of the review in the Federal Register. In reviewing its determination under section 704(h)(2) or 734(h)(2), the Commission shall consider whether, in the light of changed circumstances, an agreement accepted under section 704(c) or 734(c) continues to eliminate completely the injurious effects of imports of the merchandise. During an investigation by the Commission, the party seeking revocation of an antidumping order shall have the burden of persuasion with respect to whether there are changed circumstances sufficient to warrant revocation of the antidumping order.

Option No. 6

Amendment to § 751(c) of the Act, 19 U.S.C. § 1675(c), (technical amendment to § 611(a)(3) of the Tariff and Trade Act of 1984):

(c) REVOCATION OF COUNTERVAILING DUTY ORDER OR ANTIDUMPING DUTY ORDER.—The administering authority may revoke, in whole or in part, a countervailing duty order or an antidumping duty order, or terminate a suspended investigation, after review under this section. The administering authority shall not revoke, in whole or in part, a countervailing duty order or terminate a suspended investigation on the basis of any export taxes, duties, or other charges levied on the export of merchandise to the United States specifically intended to offset the subsidy received, *or on the basis of any international agreement unless a determination of injury is expressly required with respect to that order by the terms of that agreement.*

STATEMENT OF WILLIAM SILVERMAN, ON BEHALF OF THE CANADIAN TUBULAR PRODUCERS ASSOCIATION [1]

Mr. Chairman and members of the Committee, my name is William Silverman. I am a partner at the law firm of Dow, Lohnes and Albertson. This statement is submitted on behalf of the Canadian Tubular Producers Association (the "CTPA") in support of Section 224 of the Technical Corrections Act of 1985 (H.R. 1800), concerning the marking of imported pipes and pipe fittings by stenciling or tagging. The CTPA is a voluntary, private association of Canadian producers of pipes, tubes and pipe fittings.

In October 1984, Congress adopted Section 207 of the Trade and Tariff Act of 1984. Section 207 requires that imported pipes and pipe fittings be marked with their country of origin by die stamping, cast-in-mold lettering, engraving or etching (the "Statutory Marking Methods"). Although the CTPA does not oppose the marking of pipes and pipe fittings with their country of origin, it believes that Section 207 unintentionally created a nontariff trade barrier because for many types of pipes and pipe fittings, the Statutory Marking Methods would violate industry and customer standards, would be commercially infeasible or would render the pipes and pipe fittings unfit for their intended uses. Consequently, at the urging of the Canadian government, the CTPA, Members of the Committee and the Senate Committee on Finance, their staffs and members of the Administration, the U.S. Customs Service ("Customs") issued interim rules allowing imported pipes and pipe fittings to be stenciled or tagged with their country of origin, instead of having to be marked by the Statutory Marking Methods, while it determined how best to implement Congress's intent in enacting Section 207.

During this interim period, Committee staff members and Customs graciously entertained written and oral presentations by the CTPA and other domestic and foreign interested parties on the types of pipes and pipe fittings that should be exempt from the Statutory Marking Methods and on the permanency of stenciling as an alternative means of marking. As part of its presentation to Customs, the CTPA

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[1] This document is submitted by Dow, Lohnes and Albertson, which is duly registered under the Foreign Agents Registration Act of 1938, as amended, as an agent of the Canadian Tubular Producers Association.

submitted to Customs on February 13, 1985 a letter describing: (1) Certain types of pipes that should be marked with their country of origin by stenciling or (for small-diameter sizes) the tagging of bundles because the Statutory Marking Methods would violate industry/customer standards or would render the pipes unfit for their intended uses; (2) A study showing that stenciling is more legible and as permanent, if not more so, than die stamping or etching; and (3) A study showing the corrosive effects that the Statutory Methods of Marking would have on stainless steel and high nickel alloy tubular products.

A copy of that letter, with the above-described studies, is attached hereto as Exhibit I.

Effective May 15, 1985, Customs issued guidelines permitting certain types of pipes and pipe fittings to be marked with their country of origin by stenciling or the tagging of bundles (the "Customs Guidelines"), instead of by the Statutory Marking Methods. Although the Customs Guidelines eliminated much of the problem associated with Section 207, the uncompromising language of Section 207 forced Customs to strictly construe the statute. For example, the Customs Guidelines require that certain types of pipes (such as stainless steel pipe, hollow structural sections, structural pipe and pipe used for roll over protection systems) must be marked by the Statutory Marking Methods despite the fact that this would be commercially infeasible and unacceptable to the ultimate consumer. See, e.g., Letter from Joseph P. Cravero, Senior Tax Attorney, Deere & Company, to the Commissioner of Customs, a copy of which is attached hereto as Exhibit II.

Section 224 of the Technical Corrections Act of 1985 would amend Section 207 to permit alternative methods of marking, such a stenciling or tagging, if it is "technically or commercially infeasible" to mark the pipe or pipe fitting by the Statutory Marking Methods. The amendment clarifies Congress's intent as to the proper administration of Section 207 and reflects Congress's policy that Customs should not require the use of the Statutory Marking Methods if they would adversely affect the product's "structural integrity" or reduce its "commercial utility". Joint Committee on Taxation, *Description of the Technical Corrections Act of 1985 (H.R. 1800 and S. 814)*, (JCS-7-85), Apr. 14, 1985, at 144.

The CTPA fully supports Section 224 and urges its expeditious enactment. By explicitly recognizing that technical and commercial factors should be considered in determining the most effective method of marking pipes and pipe fittings with their country of origin, Section 224 would eliminate a potential nontariff trade barrier. Upon Section 224's enactment, Customs should immediately initiate a new administrative proceeding to modify the Customs Guidelines to conform with the Congressional intent expressed in Section 224.

It has come to the CTPA's attention that the American Iron and Steel Institute would like Section 224 modified to provide that where stenciling is permitted, it must be continuous stenciling because single-mark stenciling is not as permanent as the Statutory Methods of Marking. This is not correct; single-mark stenciling is as permanent, if not more permanent, than the Statutory Methods of Marking. This is further elaborated upon in the letter we submitted on behalf of the CTPA to George J. Weise, Esq., Professional Staff Member, House Ways and Means Subcommittee on Trade, dated May 15, 1985, a copy of which is attached hereto as Exhibit III.

In conclusion, the CTPA wishes to thank the Committee Members, their staff and Customs for recognizing the inadvertent problems created by Section 207's enactment and for promptly acting to avert what could have been a serious international trade dispute. It is our hope that Section 224 will be quickly enacted into law and that Customs immediately thereafter will initiate administrative proceedings to implement it.

EXHIBIT I

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February 13, 1985

Recd 2-13-85
U.S. Customs

BY HAND

Commissioner of Customs
Regulations Control Branch
U.S. Customs Service
1301 Constitution Avenue, N.W.
Room 2426
Washington, D.C. 20229

Re: Country of Origin Marking of Pipe and Pipe Fittings of Iron or Steel

Dear Sir:

This letter is submitted to the U.S. Customs Service ("Customs") by the Canadian Tubular Producers Association (the "CTPA") in order to supplement the Government of Canada's January 24, 1985, submission to Customs (the "GOC Submission", a copy of which is attached as Appendix A) commenting upon the new country of origin marking requirements for pipes and pipe fittings, enacted as Section 207 of the Trade and Tariff Act of 1984 ("Section 207"). The CTPA is a voluntary, private association of Canadian producers of pipes, tubes and pipe fittings.

Section 207 requires that pipes and pipe fittings be marked by means of die stamping, cast-in-mold lettering, etching or engraving. Although the CTPA has no objection to the requirement that pipes and pipe fittings be marked with their country of origin, it is our position that:

(1) Customs has the legal authority to authorize alternative methods of marking if Section 207's statutory marking methods would violate

industry standards or would render the pipes or pipe fittings unfit for their intended use.

(2) In determining whether Section 207's four statutory marking methods would render the pipes or pipe fittings "unfit for the purposes for which they were intended or [would violate] industry standards", Customs should include in its consideration whether these methods would violate customer specifications or would be contrary to the customs and usage of the industry.

(3) Pursuant to the above standards, Customs should allow alternative methods of marking (such as stenciling or tagging in bundles) for those pipes and pipe fittings described in the GOC Submission. The GOC's approach, which identifies exempted pipes and pipe fittings by ASTM, API or other specifications, would not create an administrative burden for Customs because such information is already reported on the Special Summary Steel Invoice.

(4) Because of the technical difficulty of immediately complying with any decision issued by Customs on this matter, Customs should provide for a 120-day implementation period before its decision enters into effect and should rule that its decision would not apply to pipes and pipe fittings produced before the end of that period.

I. CUSTOMS HAS THE AUTHORITY TO PRESCRIBE ALTERNATIVE METHODS OF MARKING UNDER CERTAIN CIRCUMSTANCES.

Section 207 amends Section 304 of the Tariff Act of 1930, 19 U.S.C. §1304 (1982), by requiring that imports of "pipes of iron, steel, or stainless steel" be marked with their country of origin "by means of die stamping, cast-in-mold lettering, etching, or engraving." Pub. L. No. 98-573, §207, 98 Stat. 2948, 2976 (1984). The statute's language, however, when analyzed in light of its application to specific products, is sufficiently vague and ambiguous that its mechanical application would impose a substantial hardship on foreign pipe and pipe fitting manufacturers and their American customers and would constitute a significant

nontariff trade barrier in violation of the United States' international obligations.

Congress has provided Customs with authority to issue regulations in general and with specific authority to issue regulations in particular on country of origin marking. See 19 U.S.C. §§1304(a)(1), 1624 (1982). See also 19 U.S.C. §§66, 1202 (Headnote 11) (1982). This authority is sufficiently broad enough to permit Customs to promulgate rules interpreting and implementing Section 207's requirements. In addition, Senator Danforth in his pre-enactment floor statement on Section 207 specifically said that the Senate "would expect the Secretary of the Treasury to prescribe a reasonable method of marking under section 304(a)(1) that does not preclude imported pipe and fittings from meeting industry technical specifications, such as those of the American Petroleum Institute." 130 Cong. Rec. S13,971 (daily ed. Oct. 9, 1984). Finally, in a letter to Canadian Member of Parliament Maurice Foster (a copy of which is attached as Appendix B), Senator Mattingly, Section 207's Senate sponsor, stated that, "It is my hope that this [Section 207 marking] issue can, and will, be resolved administratively by the U.S. Customs Service."

Therefore, Customs' proposal to permit alternative methods of marking under certain circumstances is within its regulatory authority. These alternative methods (described below) would fulfill Section 207's statutory purpose of indicating to the ultimate purchaser the country of origin of imported pipes and pipe fittings. In fact, in many cases, the alternative methods of marking would be a more permanent and visible method of marking than Section 207's marking methods.

II. CUSTOMS SHOULD CONSTRUE ITS STANDARDS FOR ALLOWING ALTERNATIVE MARKING METHODS TO INCLUDE CUSTOMER SPECIFICATIONS AND INDUSTRY CUSTOMS AND USAGE.

The CTPA does not oppose the marking of pipes and pipe fittings with their country of origin. Nevertheless, as correctly noted in Customs' January 9, 1985, Federal Register request for comments on this issue, Section 207's marking requirements should be read in conjunction with Section 304 of the Tariff Act of 1930, as amended. 50 Fed. Reg. 1064, 1065 (1985). Section 304 provides that, in general, imports should be permanently marked with their

country of origin "as the nature of the article or its container will permit." 19 U.S.C. §1304 (1982).

In its request for comments, Customs reconciled the provisions of Sections 207 and 304 and Senator Danforth's floor statement by proposing that pipes and pipe fittings be marked by alternative methods of marking (such as stenciling or tagging in bundles) if Section 207's marking methods would render such pipes and pipe fittings "unfit for the purposes for which they were intended or [would violate] industry standards for such articles." 50 Fed. Reg. at 1065. The CTPA agrees with this standard so long as Customs construes it to include (1) individual customer specifications, and (2) industry customs and usage.

Customs should not interpret the phrase "industry standards" to refer only to the technical specifications published by such organizations as the American Society for Testing and Materials ("ASTM") or the American Petroleum Institute ("API"). American pipe and pipe fitting customers often treat such specifications as minimum standards and impose requirements in addition to or in excess of ASTM or API specifications where necessitated by the customers' specific safety, structural integrity or design needs. In many cases, these additional customer requirements are violated if the pipes and pipe fittings are marked by using Section 207's marking methods. In these situations, the customer frequently specifies that the pipes or pipe fittings be marked by stenciling or other appropriate method.

For example, Stelco, Inc. (a Canadian tubular producer) analyzed twenty-three oil and gas transmission pipe customer specifications. Only one permitted die stamping. When directly contacted, that customer orally reported that its specifications had not been updated and that it did not now want die stamping. The remaining customer specifications either prohibited die stamping or expressly required paint stenciling. Similarly, General Motors Corp. will not permit the die stamping of certain pipe used in its steering columns. Other examples of customer specifications that either prohibit die stamping or expressly require paint stenciling are found at pages 10-11 and 12 of the GOC Submission.

Customs should not substitute its evaluation of the effects of Section 207's marking methods for legitimate customer concerns based on years of experience. Instead, Customs should sanction customer practice in its final Section 207 regulations. Therefore, in interpreting the

phrase "industry standards", Customs should include individual customer specifications that would be violated if the pipes and pipe fittings were marked using Section 207's marking methods.

Furthermore, Customs should interpret "industry standards" to include industry customs and usage. Short lengths of pipe, small diameter pipes and pipes for which surface finish is critical (such as drawn and microfinished tubing and all boiler and pressure tubing) are customarily sold or packaged in bundles that are tagged with any necessary customer information. For example, standard pipes 1.5 inches nominal in diameter are normally bundled and tagged. It is recognized throughout the industry that it would be impractical to mark individually these pipes, and thus tagging the bundles with the country of origin has been the practice in the past. Consequently, Customs should let these pipes be marked by tagging the bundles pursuant to industry customs and usage. Similarly, certain items are customarily ink stenciled, instead of paint stenciled. In these situations, Customs should allow ink stenciling.*

In summary, the CTPA agrees with Customs that alternative, reasonably permanent and legible methods of marking should be permitted if Section 207's marking methods would render the pipes and pipe fittings unfit for their intended use or if they would violate industry standards. Nevertheless, it is strongly urged that Customs include within the meaning of the phrase "industry standards" individual customer specifications and industry customs and usage.

III. CUSTOMS SHOULD PERMIT ALTERNATIVE METHODS FOR MARKING THE PIPES AND PIPE FITTINGS DESCRIBED IN THE GOC SUBMISSION.

Based upon Customs' "unfit for intended purposes" and its "industry standards" criteria, as construed above,

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* Note that ink and paint stenciling is as permanent (and often more visible) than Section 207's statutory marking methods. This is demonstrated in the study conducted by Welded Tube of Canada, Ltd., a copy of which is attached as Appendix C. In addition, ink and paint stenciling survive subsequent heat treatment to a greater extent than allowable die stamping. An indicator of the permanency of ink and paint stenciling is that the stencil is normally still visible on twenty-year old line pipe after the pipe is removed from the ground.

the GOC requested in its January 24 submission that Customs permit alternative methods for marking the pipes and pipe fittings listed therein. The GOC Submission fully details its reasons for exempting each pipe and pipe fitting from Section 207's marking methods and, in general, identifies each such pipe and pipe fitting by its ASTM or API number. To summarize, the GOC Submission requests that Customs permit alternative methods for marking the following pipes and pipe fittings:

1. Spun Iron and Steel Pipe: identified as "spun" iron or steel pipe; or as manufactured to specifications such as American Water Works Association C151; or described as "abrasion-resistant" or "wear-resistant" spun iron pressure pipe.

2. Stainless Steel and High Nickel Alloy Tubular Products: identified as being manufactured to

   (a) ASTM or ASME A213, A268, A669, A789, A270, A312, A269, A376, A790, A554, B163, B668, B677, B468, B167, B407, B423, B464, B667, A249, A688, A632, B514, B515, B516 or B517.

   (b) U.S. military specifications 1144-D, 5695, 6737, 6845-C, 8504, 8808, 8506, 8606 or 8973.

   (c) National Aeronautics and Space Administration specification Z-0007.

   (d) Manufactured from stainless steel or high nickel alloy grades meeting the following specifications or types: 405, 409, 410, 430, 439, 800, 825, 600, 625, 304, 304L, 316, 316L, 317L, 430Ti, 309, 310, 321, 322, 332, 347, S31500, S31803, N08904, N08028 and 253MA.

   See Study by Galt Laboratories Limited on the corrosive effects of die stamping, a copy of which is attached as Appendix D.

3. Mechanical Tubing: identified as "mechanical tubing"; or as ASTM A787, A512, A513 or A519.

4. Hollow Structural Sections: identified as "hollow structural sections" or "HSS"; or as ASTM A500 (A, B or C); or as manufactured to "roll over protection systems" ("R.O.P.S.") standards.

5. Oil and Gas Transmission Line Pipe: identified as "line pipe"; or as API 5L, 5LX or 5LU.

6. Oil Country Tubular Goods: identified as "casing", "oil well tubing", "drill pipe" or fittings thereof; or as API 5A, 5AC, 5AX or 5AQ.

7. Standard Industrial/Commercial Pipe: ASTM A53, A106 or A120; or identified as falling within AISI Product Code 8. Note that alternative marking only is required if such pipe is galvanized or is 1.5 inch nominal or less in diameter.

8. Electrical Conduit and Conduit Hollows: identified as "conduit"; or as ASTM A523.

9. Boiler and Pressure Tubing: identified as "boiler or pressure tubing"; or as ASTM A178, A179, A192, A210, A213 or A214.

Exempting the above-described pipes and pipe fittings would not impose an administrative burden on Customs. Such pipes and pipe fittings are currently identified (in the manner described above) on the Special Summary Steel Invoice (the "SSSI"). Item 15 of the SSSI expressly requires a description of the specifications covering the imported product. Thus, Customs officials could easily compare the above list of pipe and pipe fitting specifications with individual SSSI's to determine whether a particular entry may be marked by an alternative marking method. False statements or representations on the SSSI would be subject to Customs' normal regime of civil and criminal penalties.

In summary, based on the reasoning detailed in the GOC Submission, Customs should permit alternative methods for marking the above-described pipes and pipe fittings (i.e., ink or paint stenciling, or tagging in bundles). Such a decision would not increase Customs' administrative burden, but would instead fit with Customs' current administrative practice.

IV. CUSTOMS SHOULD GRANT A 120-DAY IMPLEMENTATION PERIOD FOR ANY MARKING RULING THAT IT MIGHT ISSUE.

The practical implementation of Section 207's marking requirements is a complex and technically sophisticated subject. Not only must Customs determine for which pipes and pipe fittings to permit alternative methods of marking, but also the size, placement and frequency of the marks for both alternative and statutory methods of marking must be responsive to varying customer needs and applications.

It is impossible for foreign pipe and pipe fitting producers to comply immediately with any final ruling issued by Customs. New equipment must be purchased, production lines revamped and new personnel hired. Equipment could not be designed and ordered during the current 120-day interim period because of the absence of Customs' rules on size, depth and frequency of the marks. Consequently, Customs should provide that any rules or regulations implementing Section 207's marking requirements would not go into effect for 120 days after their announcement and would not apply to pipes and pipe fittings produced before the end of that period. This would provide foreign pipe and pipe fitting manufacturers with a reasonable time period within which to comply with the precise rules or regulations issued by Customs.

V. CONCLUSION

Congress' intent in enacting Section 207 was "to give American buyers better consumer information about the origin of the product they are purchasing." 120 Cong. Rec. S11,768 (daily ed. Aug. 4, 1983) (statement of Sen. Mattingly). The CTPA believes that its comments permit Customs to achieve this intent without erecting a significant nontariff trade barrier. Canada is the United States'

principal trading partner. By adopting a fair and reasonable interpretation of Section 207, Customs can adhere to the statute's spirit without disrupting U.S.-Canada trade.

Sincerely,

William Silverman
Attorney for the Canadian Tubular
Producers Association

WS:csd
enclosures

cc: Thomas Lindmeier (w/enclosures)
Richard Newcomb (w/enclosures)
Paula Ilardi (w/enclosures)

APPENDIX A

GOVERNMENT OF CANADA PRESENTATION TO U.S. CUSTOMS SERVICE

COUNTRY OF ORIGIN MARKINGS UNDER SECTION 207 (2) OF THE TRADE AND TARIFF ACT OF 1984

JANUARY 24, 1985

This paper is submitted in response to changes in country of origin marking requirements as set forth in Section 207(2) of the Trade and Tariff Act of 1984. Comments were requested by the U.S. Customs Service in a notice published in the Federal Register of January 9, 1985. This submission was prepared in consultation with Canadian industry and sets out difficulties associated with Section 207 (2) that have been identified to date. The specific problems may not be exhaustive. Consequently, we would expect to bring any further problems associated with the new marking requirements, including those for fittings, to the attention of the U.S. Customs Service as they are identified.

BACKGROUND

Section 207(2) of the 1984 Act amend ction 304 of the Tariff Act of 1930, 19 U.S.C. 1304, by requiring that im s of "pipes of iron, steel, or stainless steel" and "pipe fittings of steel, stainless steel, chrome-moly steel, or cast and malleable iron" be marked with their country of origin "by means of die stamping, cast-in-mold lettering, etching, or engraving". The purpose of Section 207(2) is to "give American buyers better consumer information about the origin of the product they are purchasing". 129 Cong. Rec. S11,786 (daily ed. Aug. 4, 1983).

We understand that the purpose of the general U.S.A. marking law 19 U.S.C. 1304 is to give the ultimate purchaser in the United States the option of buying or not buying merchandise from a particular country. However, Congress and the Customs Regulations recognize that products may not require marking under certain circumstances and have provided for this by allowing for exemptions. Congress provides for 10 general exempt categories, the Customs Regulations provide for 15 categories. The categories recognize the circumstances in which the country of origin marking of articles would be impractical, unfeasible, or unnecessary. These include: i) articles incapable of being marked; ii) articles that cannot be marked prior to shipment to the United States without injury; and iii) articles that cannot be marked prior to shipment to the United States except at an expense economically prohibitive to their importation. Without these three exemptions, many products would not be able to be imported and at the same time comply with the marking law. Consequently, the general marking law allows the containers to be marked as an alternative. Section 207(2) contains no such provision and instead overrides the principles of the general marking law with respect to exempt categories.

The major problem with Section 207(2) is that it treats iron and steel tubular products as a monolithic class of goods, when in fact they represent a widely diverse spectrum of goods defined by end-use application. Many classes of tubular goods legitimately meet the above exemption criteria of the general marking law and would need to have alternative marking methods under Section 207(2).

This submission will demonstrate by example that certain classes of iron and steel tubular products cannot comply strictly with the marking procedures provided for in Section 207(2) for technical and/or economic reasons. It is,

however, generally possible to comply with the intent of Section 207(2) if, through administrative flexibility, alternative methods of conveying country of origin are provided for.

The Marking Procedures

Section 207(2) provides for marking by one of four procedures:

- cast-in-mould lettering
- etching
- engraving
- die stamping

The marketplace has over time adopted marking standards which are both commercially and technically acceptable in conveying key product identity requirements. These are:

- paint or ink stencilling (where specifications allow)
- die stamping (where specifications allow)
- marked packaging.

These standards are established in accordance with technical standards authorities such as the American Society for Testing and Materials (ASTM) and reflect an optional compromise of the following considerations:

- marking must be compatible with modern manufacturing processes
- marking must not compromise the technical nature of the goods
- marking must be sufficiently permanent to convey key product information to the end user.

The four procedures specified by Section 207(2) often do not satisfy these market criteria.

- Cast-in-mould lettering is possible only for cast iron and steel products. However, in modern spin casting techniques it is entirely unsuitable due to the fact that it would be physically impossible to extract the pipe or tube from the mould as a result of intrusion of the moulded lettering. Almost all cast iron pipes and tubes are currently produced by spin casting.

- Etching is viable only for a limited range of high quality stainless and specialty steel grades. In carbon steel grades, which constitute more than 98% of import volume, etching is much too slow. In addition etched markings may be eradicated on carbon steel grades through normal oxidation in a matter of days. If coated to prevent oxidation, the etched markings may be obscured.

- Engraving, as currently available, is extremely slow and labour intensive, and totally incompatible with efficient manufacturing processes. Certain, unproven, "high-tech" laser or electron particle engraving processes may result in superficial surface marking which, like etching, would be eradicated through normal oxidation within a very short time.

- Die stamping is the only specified marking process which may be readily adaptable to many modern high speed pipe mills. Die stamping, however, specifically contravenes a number of specifications, and is impractical for small diameter pipes.

None of the procedures reflect the practical difficulties associated with small diameter pipes and tubes, and short lengths of tubular goods. The marketplace has recognized these difficulties, however, and accordingly specifies marked packaging for:

- pipes and tubes with nominal pipe sizes (NPS) 1.5 inches and under in diameter. This is clearly documented in ASTM specifications A53 and A120 and American Petroleum Institute (API) specifications 5A and 5L
- pipes and tubes under 3 feet in length. This is clearly documented in ASTM specifications A450 and A530.

The balance of this submission will attempt to demonstrate that certain classes of goods, by their nature are not suitable for marking by one of the four prescribed methods. It provides technical and/or commercial justification for exemption from the procedures, and suggests i) suitable alternative marking procedures, and ii) a means by which the product classifications can be readily identified by U.S. Customs officials from existing Customs documentation.

Classification of Iron and Steel Tubular Goods

Standard market technology can establish at least nine separate classifications of iron and steel tubular goods.

1. Spun Iron and Steel Pipe
2. Stainless Steel and High Nickel Alloy Pipe and Tube
3. Mechanical Tubing
4. Hollow Structural Sections (HSS)
5. Oil and Gas Transmission Line Pipe
6. Oil Country Tubular Goods (OCTG)
7. Standard Industrial/Commercial Pipe
8. Finished Electrical Conduit and Conduit Hollows
9. Boiler and Pressure Tubing

1. Spun Iron and Steel Pipe

This product is produced by foundries directly from molten metal which is poured into a rotating metal mould. It can take a variety of forms depending upon application, including ductile iron used for potable water supplies, soil pipe used in plumbing, abrasion-resistant grades used in a variety of process plant installations and high alloy grades used in high temperature and highly corrosive environments. It is made to a variety of specifications depending upon end use. Ductile iron pipe is manufactured to American Water Works Association (AWWA) Specification C151.

Cast-in-mould lettering is not feasible for spun pipe as it would be physically impossible to extract the pipe from the mould. While some types of pipes, such as ductile iron may be die stamped after casting, albeit by costly manual procedures, other types, such as abrasion-resistant pipe defy all of the prescribed methods. The pipe is very hard (Brinnell Hardness Number (BHN) 475) and correspondingly brittle. The act of die stamping would not be effective and could risk cracking the pipe. The surface is rough in texture, which would render the engraved or etched markings illegible.

Alternative Marking Methods

Paint stencilling is generally accepted by the industry. It may be possible to cast the country of origin into the end of the pipe wall. This has not been proven in practice as yet, and would not be effective in conveying product origin if the pipe is subsequently cut to length.

Customs Identification

Customs form 5520 can identify this product as:

1) "Spun" iron or steel pipe

2) Manufactured to specifications such as AWWA C151

3) Described as Abrasion-resistant or wear-resistant spun iron pressure pipe.

2. Stainless Steel and High Nickel Alloy Tubular Products

These products may be produced by welding or by seamless methods and are in accordance with ASTM or ASME (American Society of Mechanical Engineers) Specifications, or a variety of customer specifications including U.S. Department of Defense (DOD) or NASA, or are identified by AISI Material Grade as Stainless Steel or High Nickel Alloys. An extensive list is outlined below.

These products are selected for their exceptional corrosion resistance under extreme environmental conditions. They are also used in the food processing industry where public safety is a major concern. The marking systems of die stamping, engraving and etching are considered to be incompatible with high alloy steels and the environmental conditions to which they are exposed. These marking systems leave localized depressions, which cause stagnant areas or pockets. With time oxygen is depleted in these areas, creates a change in localized electrolyte composition, and entrapment of corrosion products. The contact area becomes sufficiently anodic to adjacent areas to cause breakdown of passivity, and activate corrosion or rusting through electrolytic action.

Marking specifications for stainless products, are very specific as to acceptable procedures and materials which can be used, to prevent the possibility of corrosion as a result of marking.

The use of corrosion resistant material allows the use of thinner sections. With these thin sections, a system of die stamping would cause distortion and violation of wall tolerances. Etching or engraving may similarly violate dimensional tolerances. All three marking processes may render the products untestable by standard non-destructive testing (NDT) methods needed to satisfy product specifications.

Since these products are used in food and chemical process applications, marking media is carefully controlled for risk of contamination either in fabrication of the processing unit or in its operation.

Alternative Marking Methods

Ink stencilling is generally compatible with this type of product, but even that method often requires very strict technical specifications. These are clearly covered under the ASME Code for Nuclear Vessels, Section III, Appendix IX, Paragraph 3630, and ASME Code for NDT, Section V, Paragraph T630.

The U.S. Department of Labor, Occupational Safety and Health Administration, sets standards for the ink used by at least one Canadian manufacturer of stainless steel pipes and tubes.

Customs Identification

Customs form 5520 can identify these products as:

A. being manufactured to the following ASTM or ASME Specifications:

A213	B163
A268	B668
A669	B677
A789	B468
A270	B167
A312	B407
A269	B423
A376	B464
A790	B668
A554	B667

B. being manufactured to the following U.S. military or NASA specifications:

MILP	1144 D
MILT	5695
MILT	6737
MILT	6845 C
MILT	8504
MILT	8808
MILT	8506
MILT	8606
MILT	8973
NASA	Z-0007

C. being manufactured from Stainless Steel or High Nickel Alloy Grades meeting the following specifications or types:

405	304	309	S31500
409	304L	310	S31803
410	316	321	N08904
430	316L	322	N08028
439	317L	332	253MA
800	430Ti	347	
825			
600			
625			

3. Mechanical Tubing

Mechanical tubing is round or shaped tubing used in mechanical applications primarily designed by the customer. There are no standard lengths and it is generally cut to customer order. It sometimes is sold to customer specification and more commonly manufactured to ASTM Specifications A 787 (coated), A 512 (cold-drawn), A 513 (mechanical), and A 519 (seamless) specifications.

Mechanical tubing is sold to manufacturers who will further process it. Some applications are furniture, railings, ornaments, bicycles, toys, fencing, shock absorbers and blanks for automotive parts.

In general, surface finish is critical and is often pickled and oiled, coated or cold-drawn. An impression into the surface of the tube or skelp would be harmful in these applications:

Examples of mechanical tubing which would be compromised by the specified marking procedures include:

Furniture and ornamental tubes. A blemish-free surface is crucial. Subsequent processing, such as plating or painting, would tend to accentuate rather than mask the markings.

Small diameter mechanical tubes. When the product is used for the manufacture of products such as toys and bicycles, surface appearance is critical. Plating and high gloss painting accentuates the markings.

Pre-galvanized tubes. This product is manufactured from pre-galvanized steel skelp. Compliance with the marking requirements would break the zinc coating intended to protect against corrosion.

Coated tubes. Raw tubes are often coated prior to delivery to the marketplace, by a variety of processes including painting, lacquering, glass enamelling, plating and wrapping. The markings may be obscured by the coating. If marked subsequent to the coating operation, it may jeopardize the integrity of the coating.

Diamond drill rods. This product is designed to withstand severe torsional loads. Any penetration of the outer surface would constitute a critical surface defect which could result in failure during drilling, resulting in an expensive recovery operation of the drill string.

Tubes used for micro-finished parts. Tubing for mechanical parts is often processed by the customer to minimize metal removal (micro-finishing). Automotive brake sleaves is an example of this application. The marking requirements could exceed the micro-finishing depth, which is often less than .002 inches.

Tubes used in power train applications. Widely used for applications such as automotive drive shafts, they are subject to considerable torsional loads. Stampings or engravings could result in stress risers leading to failure.

Other general concerns include increased chances of inducing fatigue failure as a result of stress concentrations at the marking depressions, violation of minimum wall thickness specifications, deformation of the tubing (thin walled) as a result of mechanical marking and providing an area capable of collecting contaminants which could lead to corrosion problems.

Alternative Marking Methods

Mechanical tubing should be stencilled where the use permits and tagged where stencilling is unacceptable (e.g. due to finish length requirements or small diameter). This is specified under ASTM marking for the above mentioned specifications.

Customs Identification

Customs form 5520 can identify this product by name or as meeting the following specifications ASTM A787, A512, A513 or A519.

4. Hollow Structural Sections (HSS)

This product is typically a heavy walled pipe, round, square or rectangular in section, manufactured to ASTM Specifications A500, A, B, or C. It is primarily used for the following purposes:

- Roll Over Protection Systems (R.O.P.S.) to ensure safety in agriculture or industrial vehicles
- Columns or Joists for building construction
- Frames for machinery, vehicles and equipment
- Mine supports
- Crane booms
- Elevator shafts.

Virtually all of these applications involve an element of ensuring public safety. Die stamping, etching or engraving would compromise the product by causing a stress riser which could result in premature failure in operation or in subsequent forming techniques such as bending. Additionally, standard industry practice is to purchase steel skelp at minimum wall thickness standards. Die stamping, etching or engraving would reduce the wall thickness below minimum specification.

Alternative Marking Methods

Paint or ink stencilling.

Customs Identification

Customs form 5520 can identify this product as:

1. Hollow Structural Sections (HSS)
2. Manufactured to ASTM Specifications A500 A, B, or C.
3. Manufactured to R.O.P.S. (Roll Over Protection Systems) Standards.

5. Oil and Gas Transmission Line Pipe

Manufactured to API specifications 5L, 5LX and 5LU, this product is used for the transmission of oil and natural gas, and often operates at very high pressures. Safety is of paramount importance as failures, particularly with natural gas can have catastrophic results.

All the above specifications prohibit cold die stamping without subsequent heat treatment. Heat treatment, however, is seldom done on line pipe since specially designed facilities would be required (these are simply not available) and heat treatment would lower product strength.

Product diameter ranges from .405" to 56" O.D. and sometimes beyond. In many instances pipe is shipped with a permanent protective coating for its entire length save the last inch on each extreme which will be at the weld. Paint stencilling is normally requested by customer to identify source mill of each length and on larger diameter (over 16" O.D.) the stencil is inside the pipe. Die stamping could lead to the development of stress risers. Many oil and gas transmission companies specifically ban die stamping. Examples are shown at the end of this section.

Alternative Marking Methods

Sizes to 1.5" nominal should be bundled and tagged. Sizes above 1.5" should be paint stencilled in accordance with the predominant customer specifications which tend to be based on API requirement depending on temperature expected and the conditions which are likely to be encountered.

Customs Identification

Customs form 5520 can identify this product as: (1) Line pipe (2)Manufactured to API Specifications 5L, 5LX or 5LU.

Oil and Gas Transmission Pipe
Customer Specifications

Koch Oil, Division of Koch Industries -

- Specifications for Large Diameter E.R.W. Line Pipe for Wet, Sour Gas Service, Section 9.5 - "No die stamp marking shall be permitted on either coil or pipe."

- Specification for Small Diameter E.R.W. Line Pipe for Wet, Sour Gas Service, Section 9.5 - "No die stamp marking shall be permitted on either coil or pipe."

Aminoil U.S.A. - Specification S-505, Section 9.1 - "Marking shall not be applied with cold die stamping."

Exxon Company, U.S.A. - Specification No. 5663-3-002, Section 9.3 - "Cold die stamping of the pipe shall not be permitted."

Conoco Inc. - Line pipe specification, Milne Point Project - Section XI "Pipe shall not be metal die stamped."

All American Pipeline Company - Specification for High Test Line Pipe, Section 11.6, "Cold dye stamping of either the finished pipe, or skelp used in its manufacturing, is prohibited."

Texas Eastern Transmission Corporation - Specification No. 2207, Section 12.2, "Markings shall be stencilled with paint."

Gulf Oil - Pipeline materials specification GS-8, Section 7.1 - "No die stenciling (hot or cold) shall be permitted."

Michigan Wisconsin Pipe Line Company (now ANR Pipeline Co.) - Specification for DSAW Line Pipe, Section 12.0 - "Steel dies or other marking tools which indent the metal shall not be used."

Northwest Alaskan Pipeline Company - Specification SP-4680-50-26, Section 9.1, "Die stamping (hot or cold) shall not be allowed."

6. Oil Country Tubular Goods (OCTG)

OCTG comprise casing, oil well tubing and drill pipe and fittings thereof used in the production of and exploration for oil and natural gas. These products are produced to API specifications 5A, 5AC, 5AX and 5AQ. It may also be identified as Limited Service Casing (LSC) which is often an outlet for downgraded API product.

Specifications API 5A clearly states that tubing in sizes 1.05 inches and 1.315 inches (this corresponds to NPS of 1.5 inches and under) be marked with metal tags. Specification 5AC and the new API specification 5AQ restrict the use of die stamping.

These products, particularly when used in highly corrosive "sour" atmospheres or at great depths, closely restrict stamping to minimize the risks of concentrated corrosion around the area indented. High strength OCTG, over 80,000 PSI in yield strength, are produced near the maximum allowable hardness. Die stamping would create a notch from which a crack could propogate. It would also harden the pipe at the stamp point increasing the chance of failure. A failure leading to a blowout in a sour gas well may result in the release of lethal hydrogen sulfide gas and poise a major threat to adjacent populated areas.

Customers of OCTG recognize these problems and often specify that OCTG be paint stencilled only. A sample listing follows this section.

Alternative Marking Methods

Paint stencilling is the universally accepted marking procedure.

Customs Identification

Customs form 5520 can identify the product by the names: Casing, oil well tubing or drill pipe or fittings thereof or by API Specifications 5A, 5AC, 5AX or 5AQ.

U.S. Customer Specifications
Oil Country Tubular Goods

Shell U.S.A. - Specifications for C75, C80, C90, CS95 casing: Section 11.5 - "No die stampings shall be applied."

- Specifications for CHS 110, CHS 125, CHS 135 casing: Section 11.4 - "No die stamping shall be applied unless specifically authorized in writing by the purchaser."

Exxon Corp. - Deep sour gas well specifications for grade 95, 110, 125 casing. Section 11.2 - "Casing and couplings shall be paint stencilled only. No die stampings shall be applied."

ARCO - Specification 84.05.07 T "Restricted Yield 100 Grade Protective Casing". Section 10.2 - "Casing and couplings shall be paint stencilled only. No die stamping shall be applied."

7. Standard Industrial/Commercial Pipe

This class of tubular goods is made to ASTM Specifications A53, A106 and A120. It is widely used for a variety of industrial or commercial piping needs and may be sold with or without couplings either black or galvanized (zinc coated).

Alternative Marking Methods

Alternative marking methods are required for a portion of the product range, namely pipes 1.5" nominal and less which are impractical to die stamp, etch, or engrave, and all galvanized pipe, the surface of which has been zinc coated to prevent corrosion.

Pipes 1.5" nominal and less are normally bundled and tagged in accordance with ASTM specifications. That same provision should be provided for in country of origin marking requirements. Galvanized pipe should be paint or ink stencilled as also provided for by ASTM specifications.

Custom Identification

Customs form 5520 can identify this product as:

1. meeting specifications ASTM A53, ASTM A106, ASTM A120
2. AISI Product Code 18
3. Visual appearance of the product to distinguish between galvanized and black pipe.

8. Finished Electrical Conduit and Conduit Hollows

These products are used for encasing electrical wiring and cable installations. Conduit is manufactured to ASTM Specification A523. It is galvanized for corrosion protection which is absolutely necessary to ensure safety standards are met. Die stamping, etching or engraving would break the zinc coating and jeopardize the galvanic protection.

Alternative Marking Methods

Sizes up to 1.5" nominal should be bundled and tagged. Larger sizes should be paint or ink stencilled.

Customs Identification

Customs form 5520 will identify the products as:

1. "conduit"
2. Manufactured to specification ASTM A523.

9. Boiler and Pressure Tubing

These products are manufactured to ASTM Specification A178, A179, A192, A210, A213 and A214.

This type of tubing is used in applications where a pressure vessel is created. As such it is subject to stringent surface and quality specifications. Die stamping, etching or engraving would create a potential stress riser.

Customers purchasing this product to manufacture pressure vessels to American Society of Mechanical Engineers (ASME) Pressure Vessel Code NCA - 3866.6(2) are required to avoid "sharp discontinuities" such as could be introduced by die stamping, etching or engraving.

Alternative Marking Methods

The product specifications provide for bundling and tagging. Because the end user requires test certificates to ensure standards are met, these could be available for customs verification.

Customs Identification

Customs form 5520 can identify these products by:
1. by name
2. as manufactured to ASTM Specs. A178, 179, 192, 210, 213 and 214.

CONCLUSIONS

Marking procedures for tubular goods should be established primarily by ASTM and API which set the standards for the marketplace giving consideration to the needs and capabilities of both suppliers and consumers. Iron and steel tubular goods are not a monolithic class of manufactured goods, but rather constitute an enormous range of products specifically tailored for an equally large range of market applications. Country of origin markings methods should, therefore, provide for sufficient flexibility to comply with the intent of the regulation without compromising the integrity of the product, or the efficiency with which the tubular goods are manufactured or consumed by U.S. customers.

If the new marking requirements are to be retained, many of the fundamental problems created by Section 207(2) could be ameliorated by expanding the range of options available in conveying country of origin. These could include:

- line marking (paint or ink)
- marking of containers (tagged bundles, marked boxes)

We also believe that the U.S. Customs Service should allow, on a case by case basis, alternative marking methods or exemptions from markings where adequate justification can be demonstrated.

It is recognized that Section 207(2) does specifically state that the exempted categories mentioned above in the general law will not apply in the case of Section 207(2) merchandise. However, the process of U.S. Customs determining, during the 120 day review period, what products are not susceptible to marking under Section 207(2) methods is essentially one of administering 207(2) in a manner which reflects the intent of Congress while not restricting trade. Consequently, it is essentially a process of applying, to some extent, the exemptions already contained in the general statute which exist for very good reasons. We believe that exemption from the four stated marking procedures for those classes of goods which can demonstrate that they will be technically or commercially compromised through marking is fully in accordance with the objectives of the U.S. Customs review.

APPENDIX B

MACK MATTINGLY
GEORGIA

REC'D FEB - 5 1985
SENATE OFFICE A S C

UNITED STATES SENATE
WASHINGTON D C 20510

January 23, 1985

The Honorable Maurice Foster
Member of Parliament for Algoma
The House of Commons
Room 534-C, Center Block
Ottawa, Ontario K1A0A6
CANADA

Dear Mr. Foster:

I would like to thank you for stopping by my office last week to discuss country-of-origin marking requirements for pipes, pipe fittings, and other items. I understand that there are producers, such as Algoma Steel, who are finding it technically impossible to comply with the requirements. It is my hope that this issue can, and will, be resolved administratively by the U.S. Customs Service. As I hope I made clear during our conversation, this country-of-origin requirement was not intended to create a non-tariff trade barrier to products from Canada or any other of the United States' trading partners.

It was a pleasure to see you and I hope we will meet again soon.

Sincerely,

Mack Mattingly

APPENDIX C

PERMANENCY OF STENCILLING

JANUARY 17, 1985

Chris Lancashire
Welded Tube of Canada Ltd.
Quality Control Dept.

Page 1...

PURPOSE:

1. The purpose of this report is to investigate the permanency of stencilling on metal tubing and pipe.

2. To compare stencilling permanency with die stamping and chemical etching.

EQUIPMENT:

1. Plastic "Canada" stencil

2. Foam roller

3. Dykem stain

   Type: White DW

   Manufactured by: Dykem Company

   Address: 8501 Delport Dr.
   St. Louis, Mo.
   U.S.A.

   Contact: Mr. Dieckman (314) 423-0100

4. Chem-Etch ink

   Type: P1001 - white printing ink

   Distributed by: Chem-Etch and Stamp of Canada Ltd.

   Address: 5200 Dixie Rd., Unit 30
   Mississauga, Ontario
   L4W 1E4
   Canada

   Contact: Mr. Wright (416) 624-1675

5. J2 professional quality spray paint

   Type: High gloss enamel

   Distributed by: J2 Products
   Sawill Ltd.

   Address: 595 Oster Lane, Unit 3
   Concord, Ontario
   L4K 1B1
   Canada

   Contact: Mr. J. Sanders (416) 669-9410

6. Hand die stamp with 3/16" safe-butt, sharpface characters, stamps to a maximum depth of .050"

7. Monode electro-chemical marking system (used for etching and as the power supply for the accelerated corrosion tests)

EQUIPMENT CONT'D

8. Bondex dry acid crystals (sulfamic acid)

9. Flux stripper 5
(this is a specialized solvent for professional use only. It is used for the removal of grease, oil, silicone, hydrocarbon oils, resin, fluxes, waxes and varnishes)

10. 639 industrial solvent

11. 3M - 80 grit sandpaper

12. Steelwool

13. Dykem remover and thinner #138
(this product is specially manufactured for the removal of dykem stains)

14. Twenty (4" long x 2 1/8" square x .131 thick) 1022 steel specimens

METHOD: (SPECIMEN PREPARATION)

Eighteen of the specimens were divided into six groups of three: Group 2, Group 3, Group 4, Group 5, Group 6 and Group 7.

Each of the three specimens in the groups were designated with an A,B or C. Each of the specimens were stencilled with "Canada" on two sides.

Group A: High gloss enamel (paint)
Group B: Dykem (stain)
Group C: Printing (ink)

Groups six and seven also had the word "Canada" etched onto the same two sides as the stencilling.

The two remaining specimens were stencilled with stain, hand die stamped and chemically etched with the word "Canada". These specimens were designated X and Y.

The specimens were allowed to cure for a twenty-four hour period.

TEST ONE

ACCELERATED CORROSION TEST, PART ONE (SPECIMEN X)

METHOD:

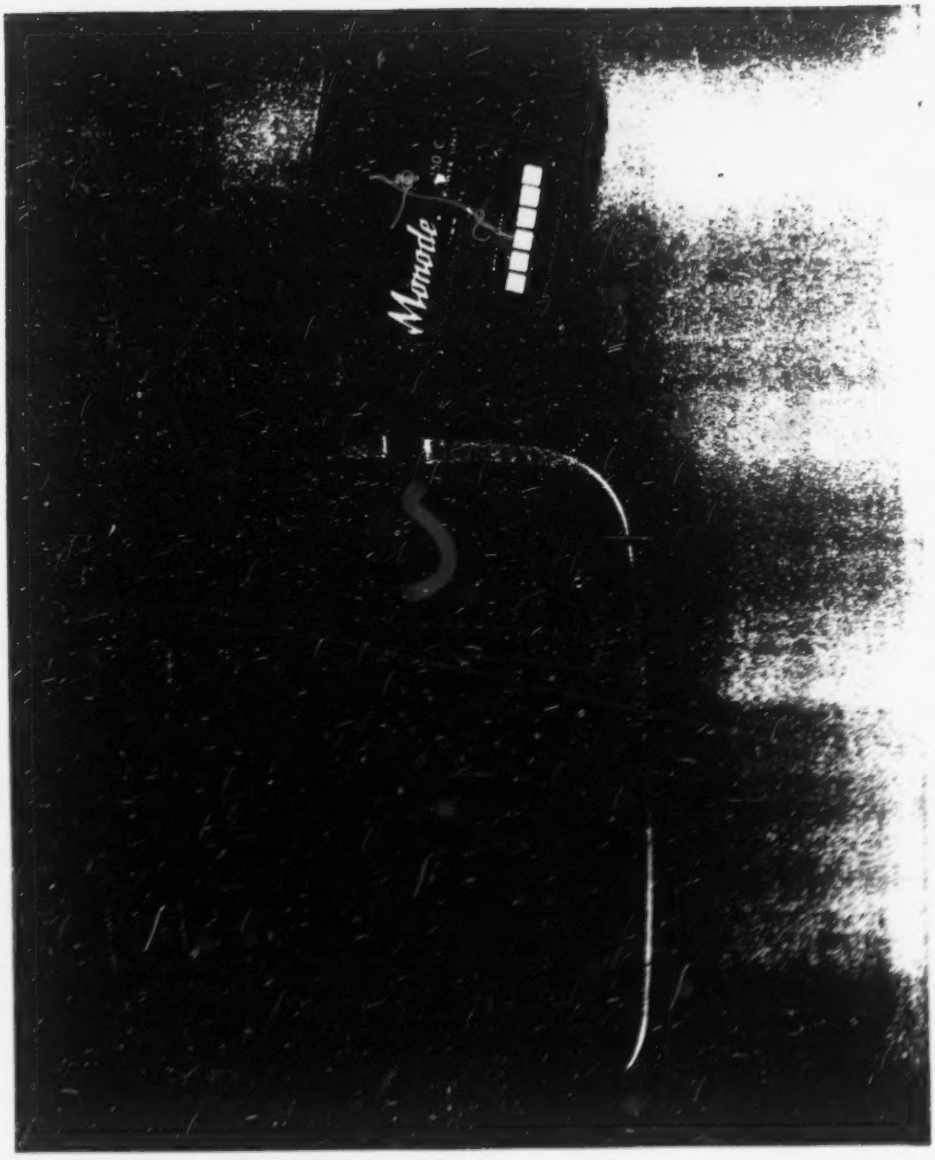
A salt water bath was prepared and specimen X was placed in the bath with the stencilled, etched and die stamped face submerged.

Using a D.C. power supply the negative lead was connected to the top of the specimen. The positive lead was submerged in the bath approximately two inches from the submerged face of the specimen. The power was then turned on. (see figure one, "Test set-up")

This results in an attack on the face of the specimen by positive ions from the positive lead. These positive ions corrode the face much the same way atmospheric corrosion attacks exposed metal, except of course at a much faster pace.

The specimen was allowed to corrode for exactly one hour.

SPECIMEN X Page 6...



TEST ONE

ACCELERATED CORROSION TEST, PART ONE (SPECIMEN X)

RESULTS AND OBSERVATIONS

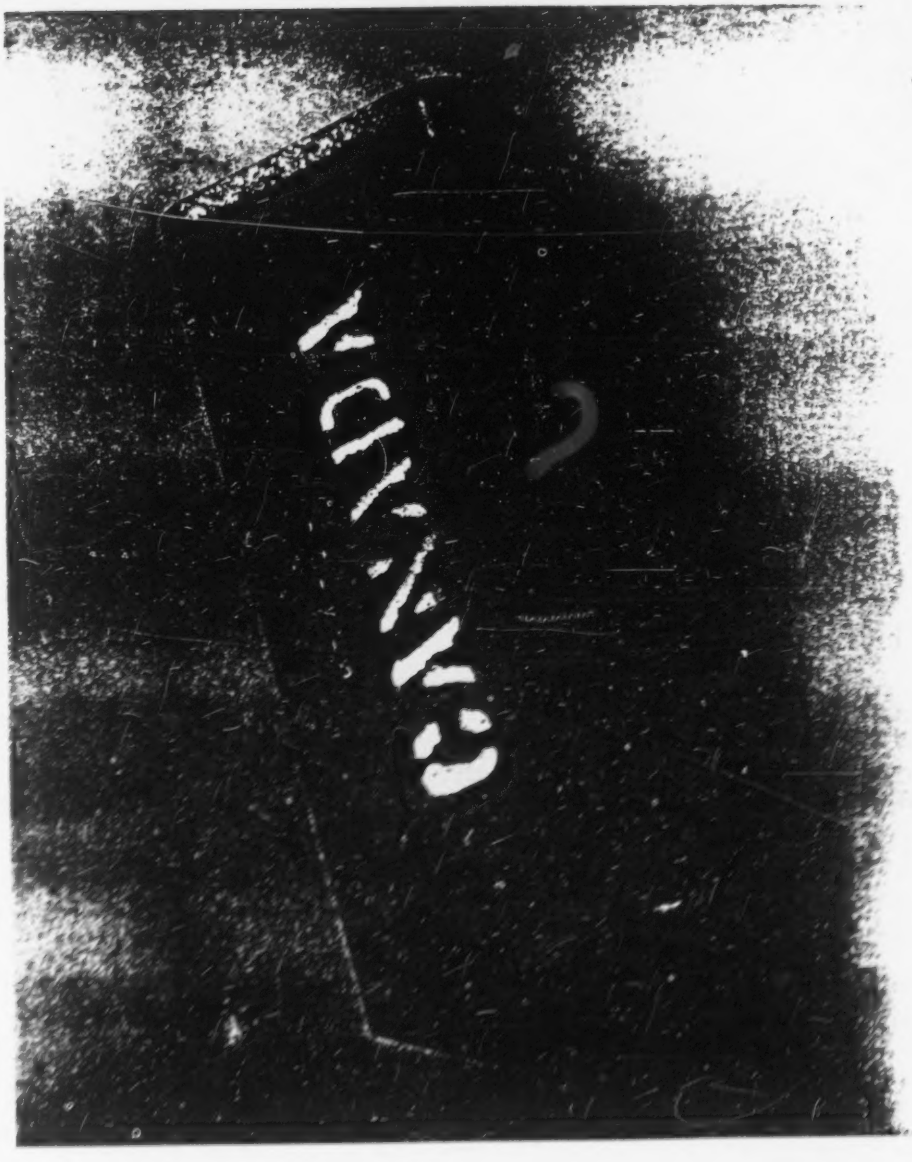
.005" to .006" was corroded from the face.

The etched word "Canada" was completely corroded from the face of the specimen. This is because the etching had only penetrated the surface approximately .003".

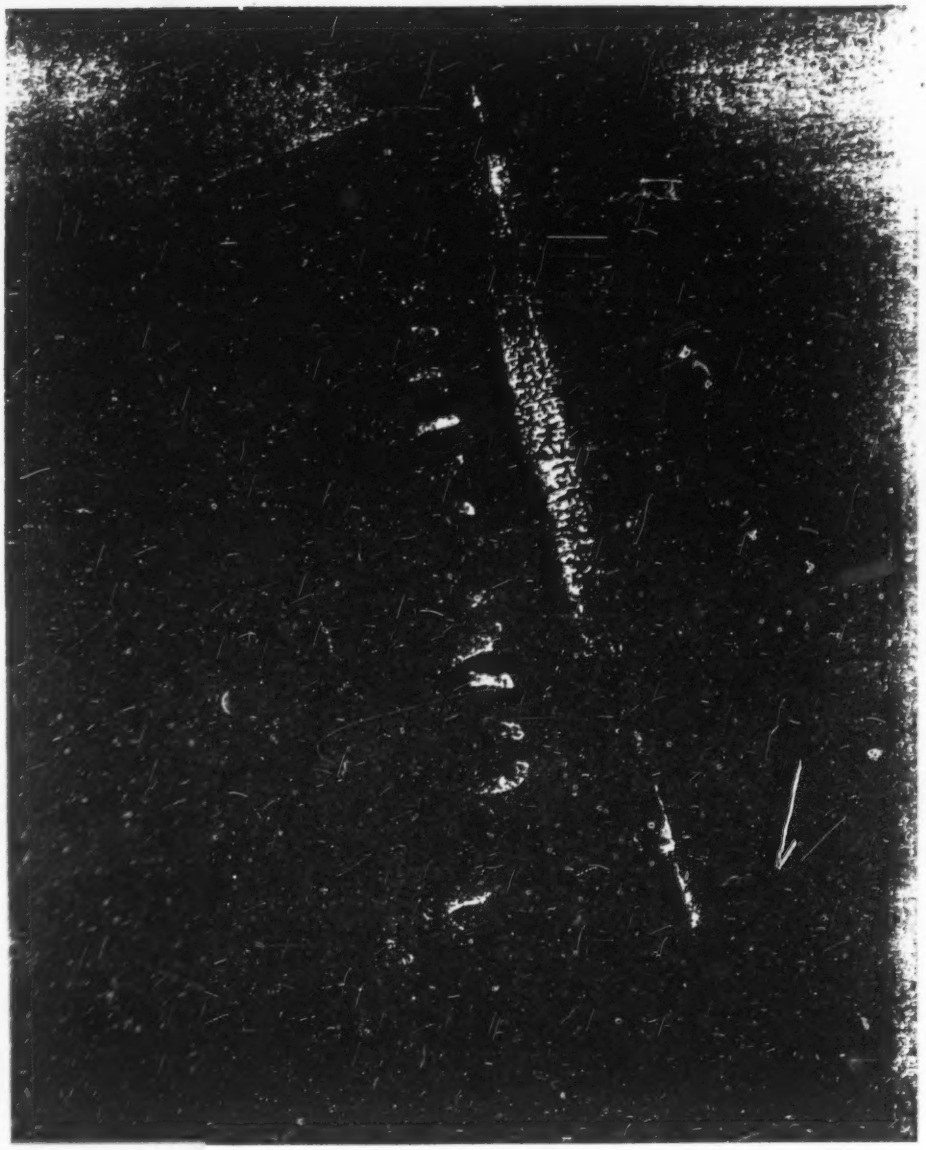
The stain stencil of the word "Canada" showed that some of the stain did come off, but the majority of it remained. The stain also protected the metal under it from corroding significantly. Since the specimen face lost .005" - .006", the stencilled letters were actually left .005" - .006" higher than the face of the specimen.

The die stamped "Canada" seemed to be relatively unaffected. However, since the wall thickness was reduced from .131" to .125", the die stamped "Canada" would also be .006" further through the wall than it was before the corrosion started. This die stamped area would continue to corrode at the same rate as the face, therefore eventually producing the first "corroded through" area on the specimen.

SPECIMEN X BEFORE Page 8...



SPECIMEN Y AFTER Page 9...



TEST ONE

ACCELERATED CORROSION TEST, PART TWO (SPECIMEN Y)

METHOD:

Specimen Y was thoroughly drenched in a strong salt-water solution. The specimen was then left to oxidize for a thirty six hour period.

RESULTS AND OBSERVATIONS:

Die stamped indication:

The oxidization obscured the word "Canada" to such a degree that a person would have to look very closely to make it out. (refer to specimen Y)

Stencilled indication:

The stencilled word "Canada" remained the most prominent and legible indication on the specimen, as it was before the oxidation took place.

Etched indication:

Although the etched indication could still be seen under close scrutiny, several of the letters were partially or fully obscured by the oxidation.

TEST TWO

SULFAMIC ACID SOAK AND WIPE

METHOD:

A bath of 50% sulfamic acid and 50% water was prepared.

Samples A2, B2 and C2 were placed in the solution. The samples remained in the bath for a period of three hours. The samples were then removed from the bath and vigorously wiped with a coarse cloth for 30 minutes, or until the stencilling was completely removed.

RESULTS AND OBSERVATIONS:

The sections of the samples which were in the acid had a much shinier appearance than the areas not submerged.

Specimen A2

Stencilled with paint, this specimen showed only a slight hint of deterioration. After rubbing the specimen with a cloth for 30 minutes, no further deterioration could be seen.

Specimen B2

Stencilled with stain, this specimen showed no signs of deterioration of the stencilled area. Thirty minutes of rubbing with a coarse cloth did not have any visible affect upon the stencilled area. (refer to figure four "Before" and figure five "After")

Specimen C2

Stencilled with printing ink, this specimen showed slightly more deterioration than A2. However the stencilling remained perfectly legible and did not deteriorate any further after a coarse cloth rubbing for 30 minutes. (refer to figure four "Before" and figure five "After")

FIGURE 4 BEFORE

Page 12...

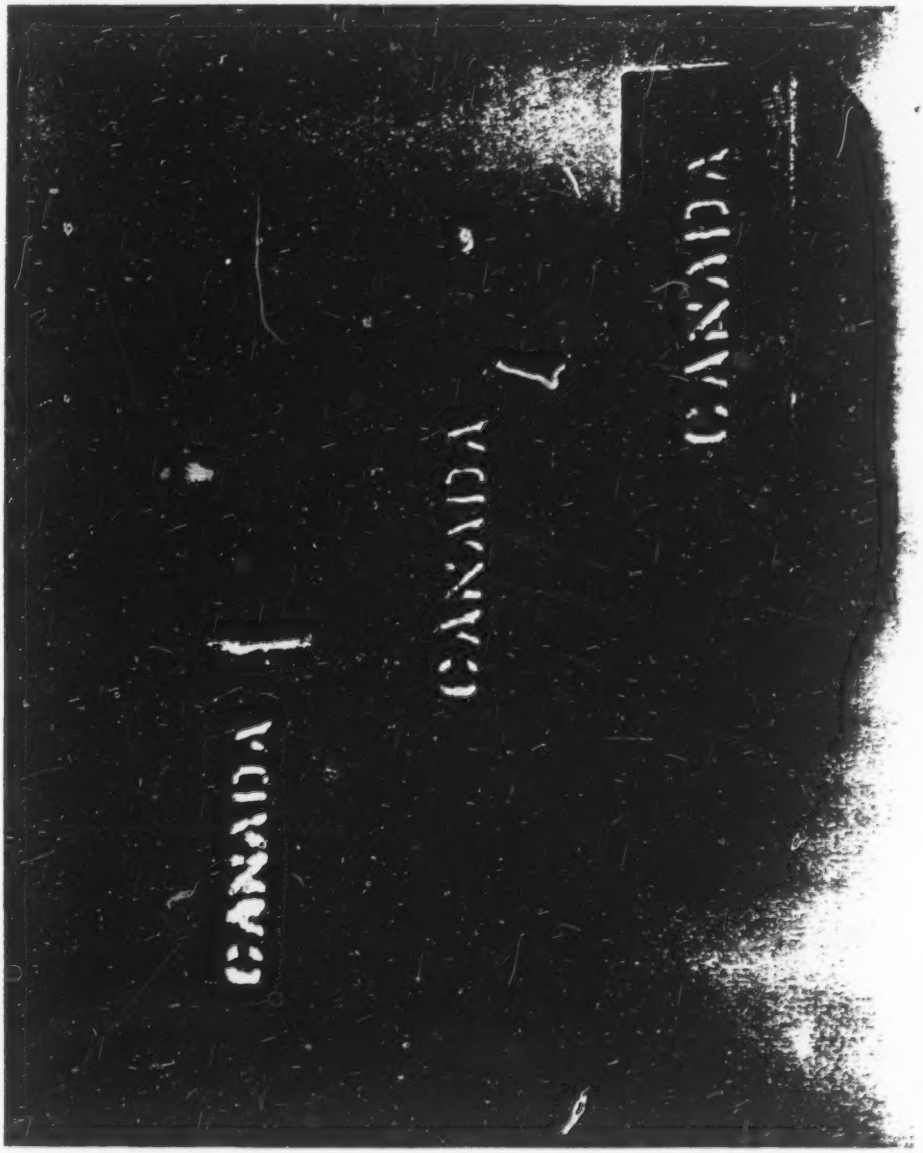
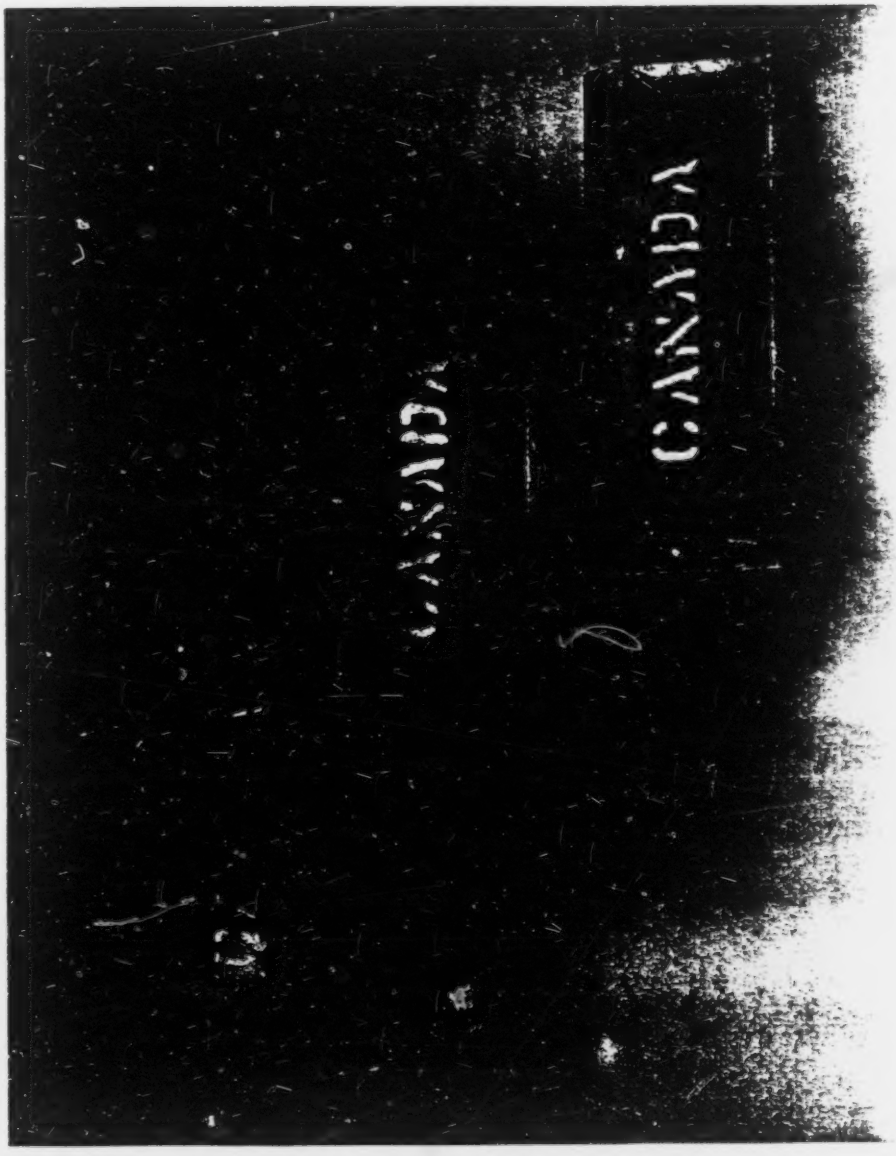


FIGURE 5 AFTER Page 13...



TEST THREE

FLUX STRIPPER 5 AND SOLVENT WIPE

METHOD:

Specimens A3, B3 and C3 were sprayed with flux-off on the stencilled area. They were then vigorously wiped with a coarse cloth for 30 minutes or until the stencilling had been completely removed.

RESULTS AND OBSERVATIONS: (refer to figure six "Before" and figure seven "After")

Specimen A3

Stencilled with paint, the solvent completely removed the stencilled word "Canada" after fifteen seconds of rubbing.

Specimen B3

Stencilled with stain, the solvent completely removed the word "Canada" after fifty five seconds of rubbing.

Specimen C3

Stencilled with printing ink, the solvent completely removed the word "Canada" after thirty five seconds of rubbing.

FIGURE 6 BEFORE Page 15...

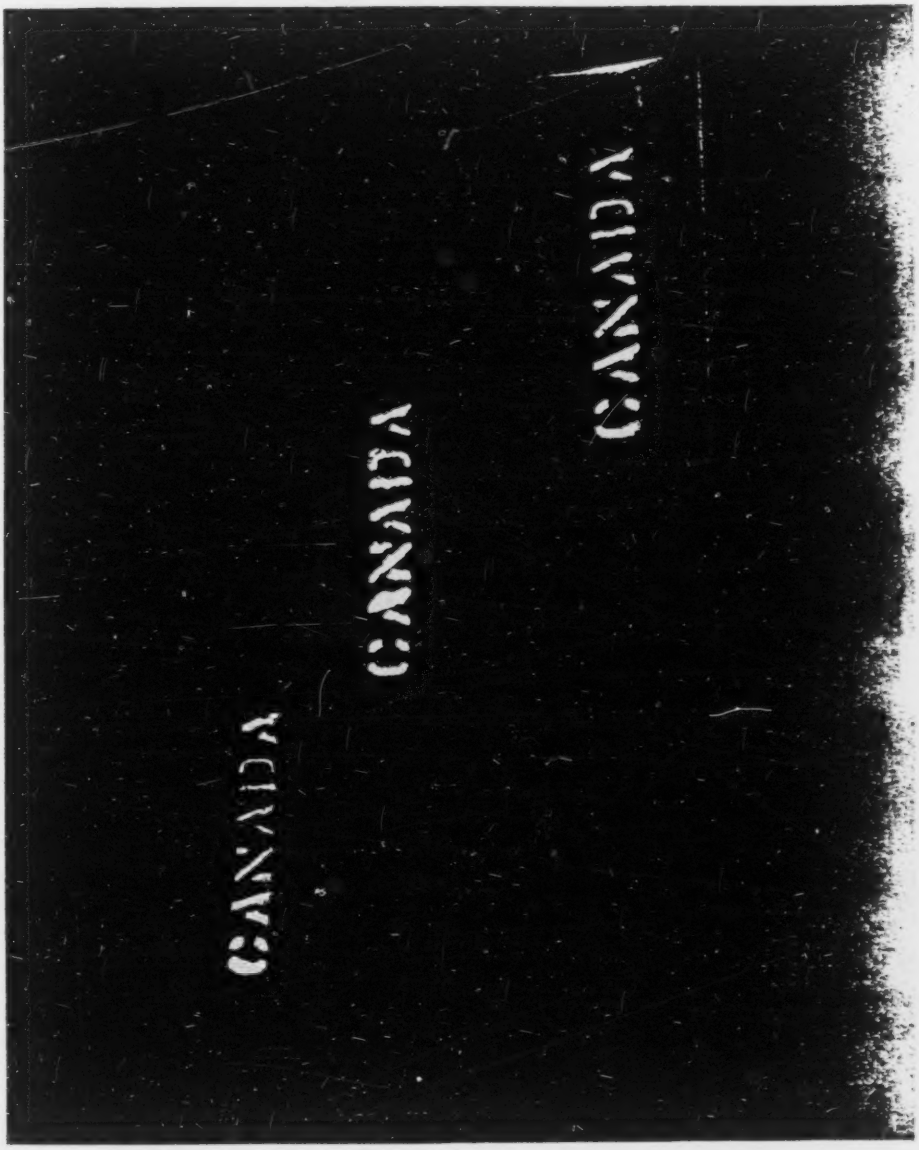
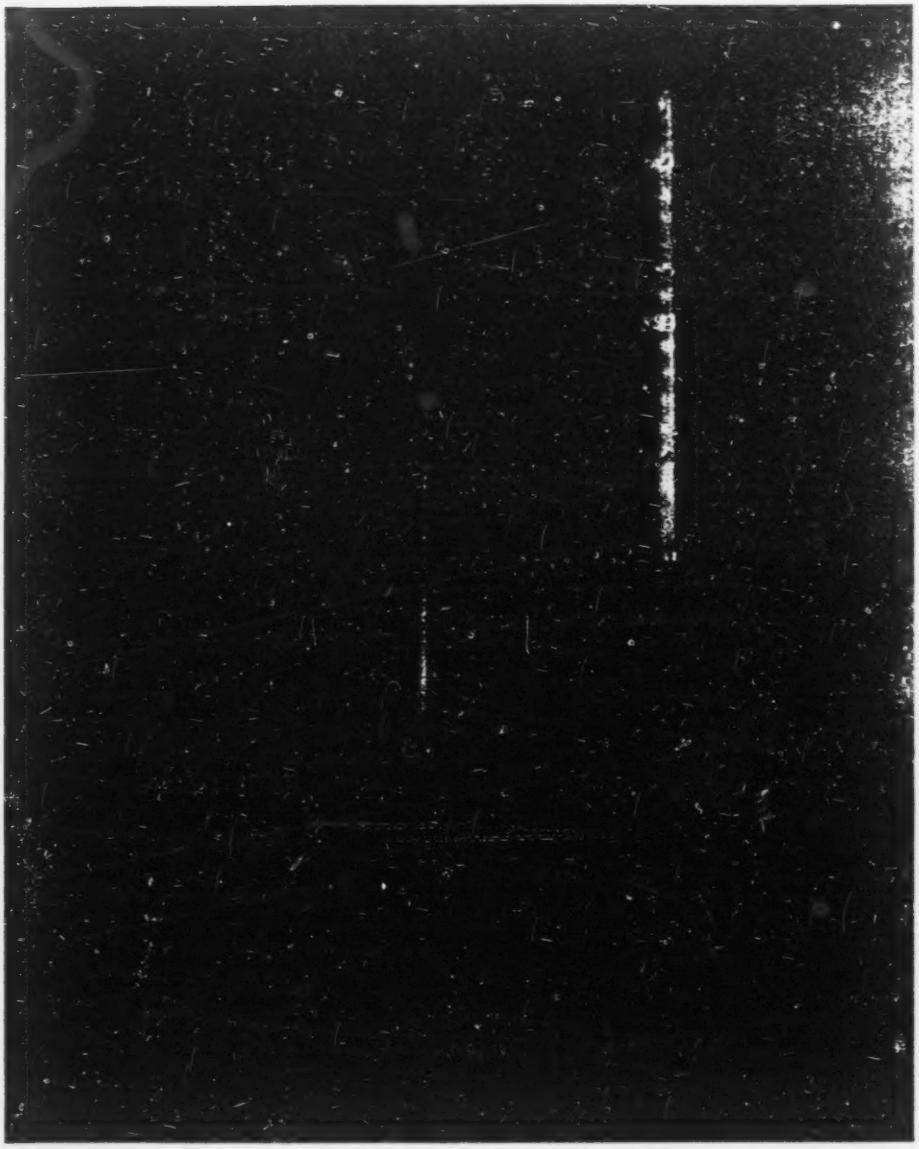


FIGURE 7 AFTER

Page 16...



TEST FOUR

639 INDUSTRIAL SOLVENT AND WIPE

METHOD:

Specimens A4, B4 and C4 were wiped with a cloth saturated in 639 solvent. The specimens were wiped for 30 minutes or until the stencilling was completely obscured.

RESULTS AND OBSERVATIONS: (refer to figure eight "Before" and figure nine "After")

Specimen A4

Stencilled with paint, the stencilled area was completely removed after thirty seconds of vigorous rubbing.

Specimen B4

Stencilled with stain, after thirty minutes of rubbing only a slight fading could be observed on the stencilled area.

Specimen C4

Stencilled with printing ink, after thirty minutes of rubbing the stencilled area had faded significantly. However, the majority of the fading took place in the first two to three minutes. The word "Canada" could still be easily made out.

FIGURE 8 BEFORE Page 18...

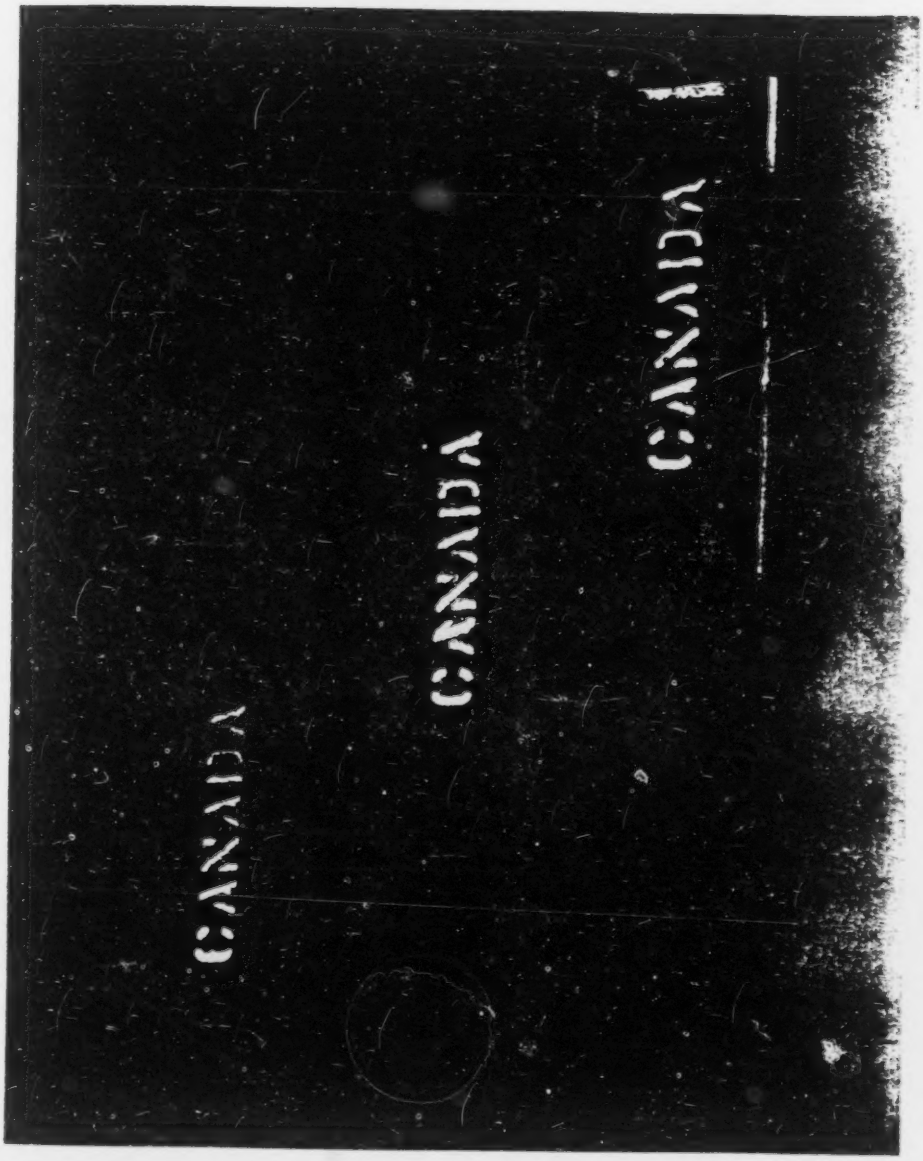
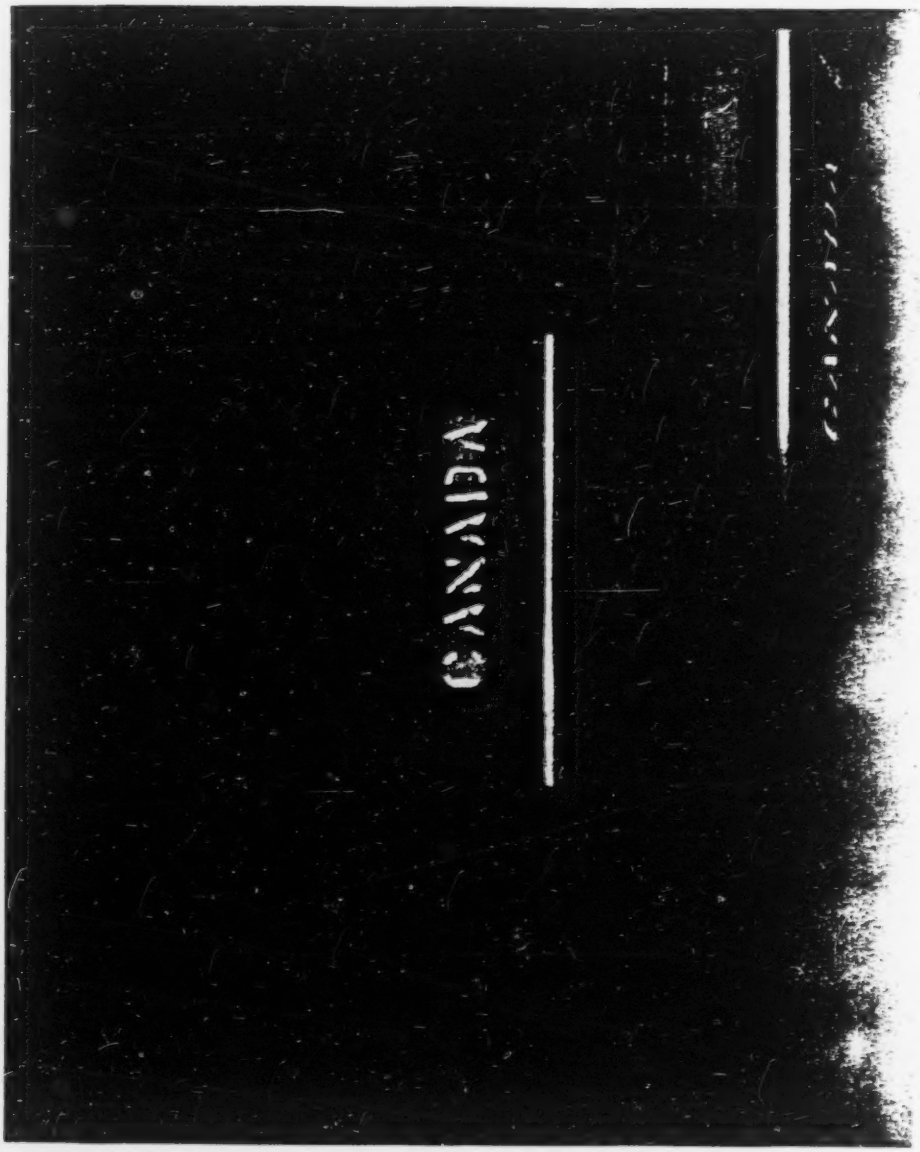


FIGURE 9 AFTER

Page 19...



TEST FIVE

DYKEM REMOVER AND THINNER #138

METHOD:

Specimens A5, B5 and C5 were wiped with a cloth saturated in dykem remover and thinner #138. The specimens were wiped for 30 minutes or until the stencilling was completely removed.

RESULTS AND OBSERVATIONS: (refer to figure ten "Before" and figure eleven "After")

Specimen A5

Stencilled with paint, the stencilled area was completely removed after only five seconds of rubbing.

Specimen B5

Stencilled with stain, the stencilled area was completely removed after twenty seconds of rubbing.

Specimen C5

Stencilled with printing ink, the stencilled area was completely removed after fifteen seconds of rubbing.

FIGURE 10 BEFORE Page 21...

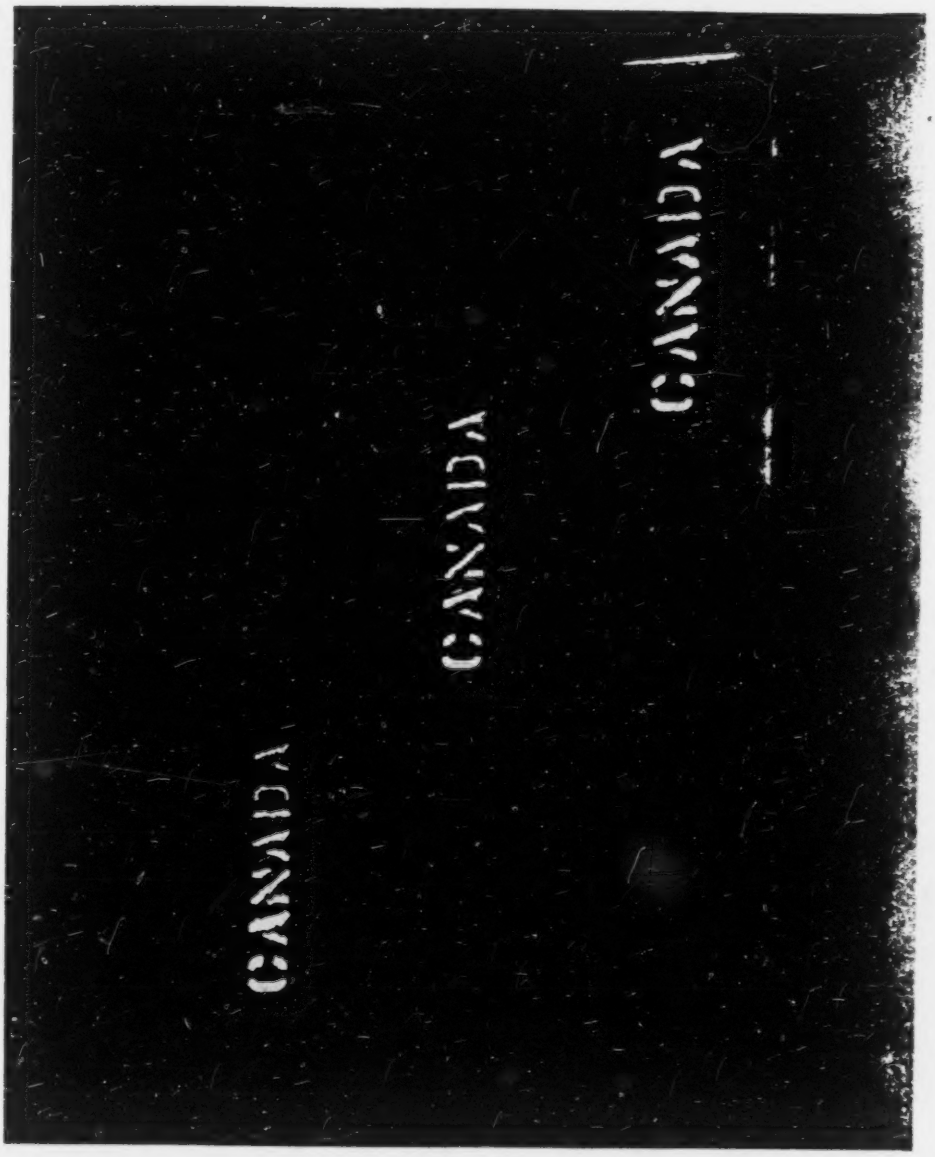
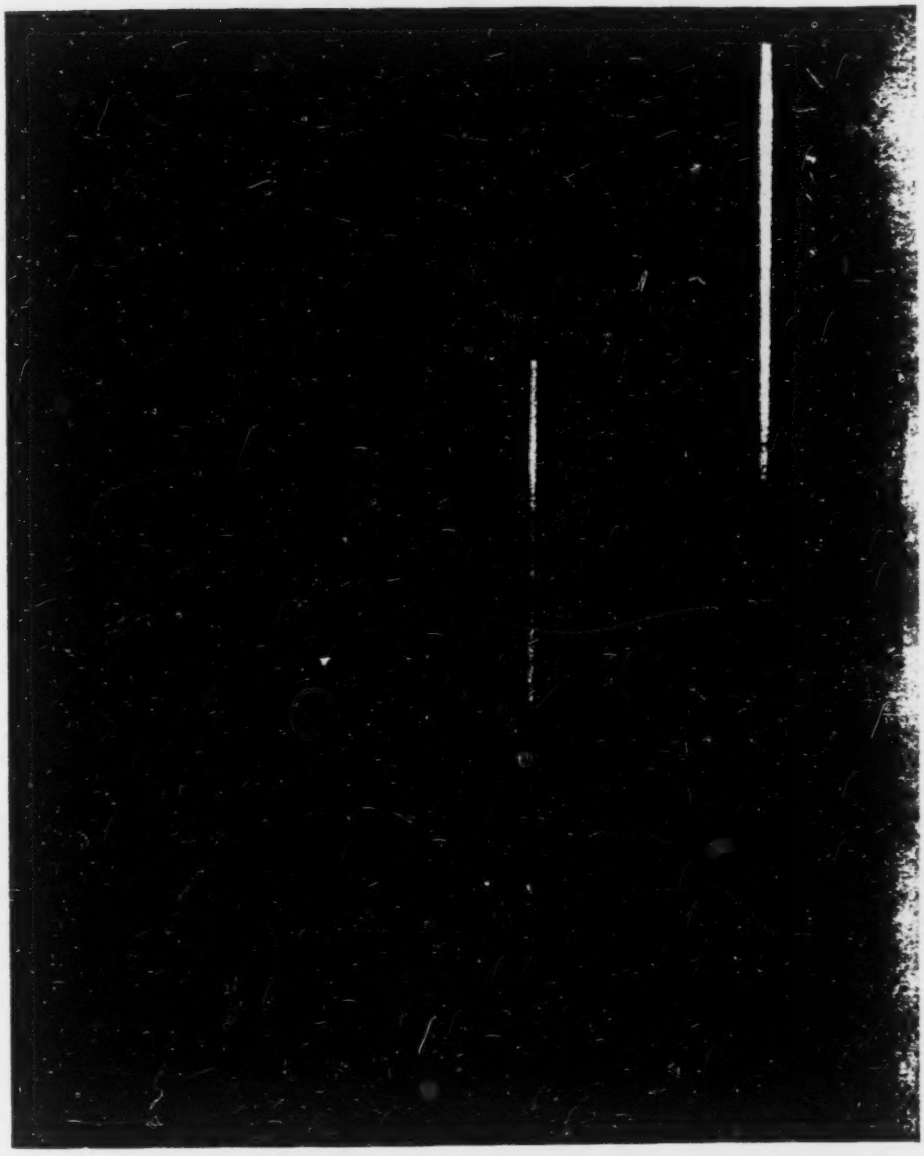


FIGURE 11 AFTER Page 22...



TEST SIX

STEELWOOL

METHOD:

Specimens A6, B6 and C6 were both stencilled and chemically etched with "Canada" on two sides: one side on each specimen was subjected to a vigorous rubbing with steelwool on both the stencilled and chemically etched areas. They were rubbed for 30 minutes or until the indications were completely erased.

RESULTS AND OBSERVATIONS:

Specimen A6

Stencilled with paint and chemically etched, after five minutes of rubbing on the stencilled area, the paint was completely removed, leaving no sign of the word "Canada". It took 9.5 minutes of rubbing to eliminate the etched indication of the word "Canada".

Specimen B6

Stencilled with stain and chemically etched, after thirty minutes of rubbing on the stencilled area, the word "Canada" was completely erased. After thirty minutes of rubbing on the etching of "Canada", the indication was almost completely erased. However, under close observation portions of the word could still be made out.

Specimen C6

Stencilled with printing ink and chemically etched, after thirty minutes of rubbing both the stencilled and etched indications could still be made out under close observation.

FIGURE 12 BEFORE Page 24...

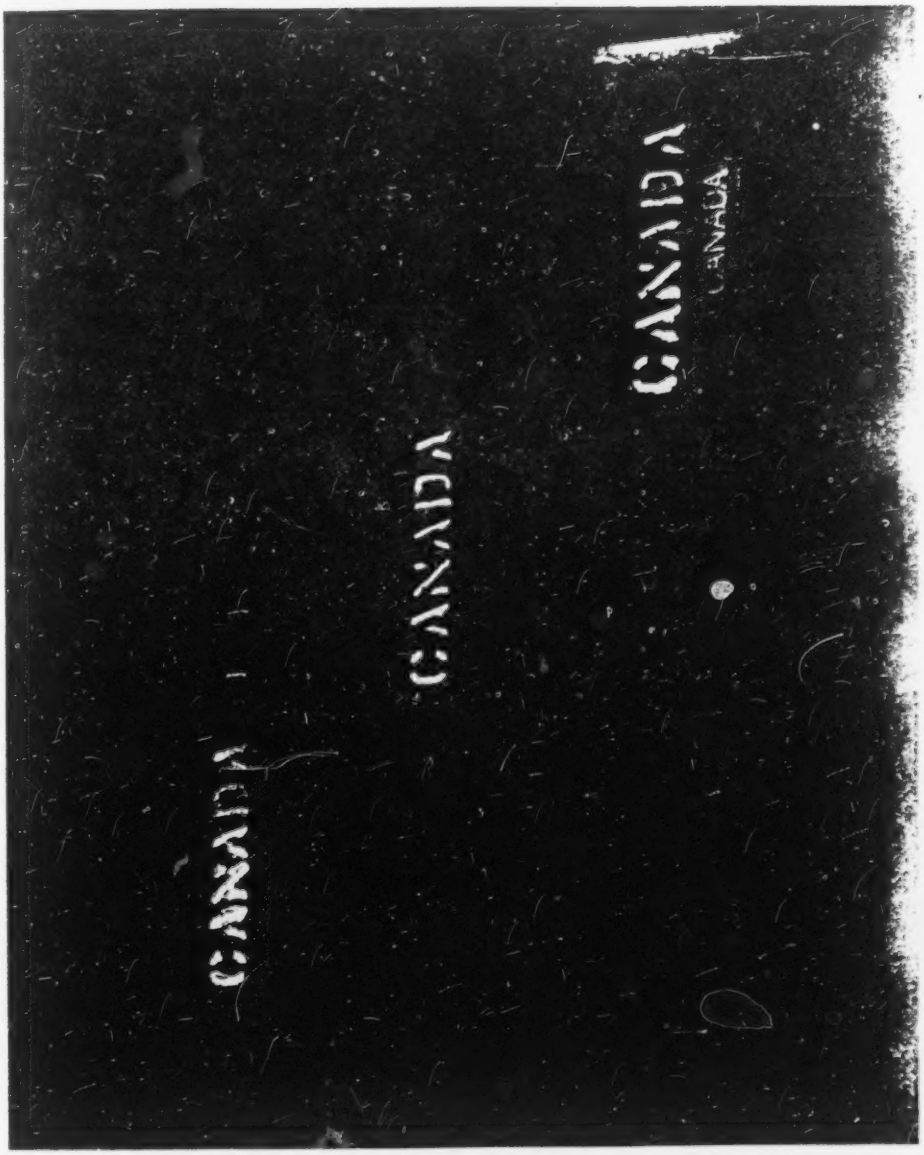
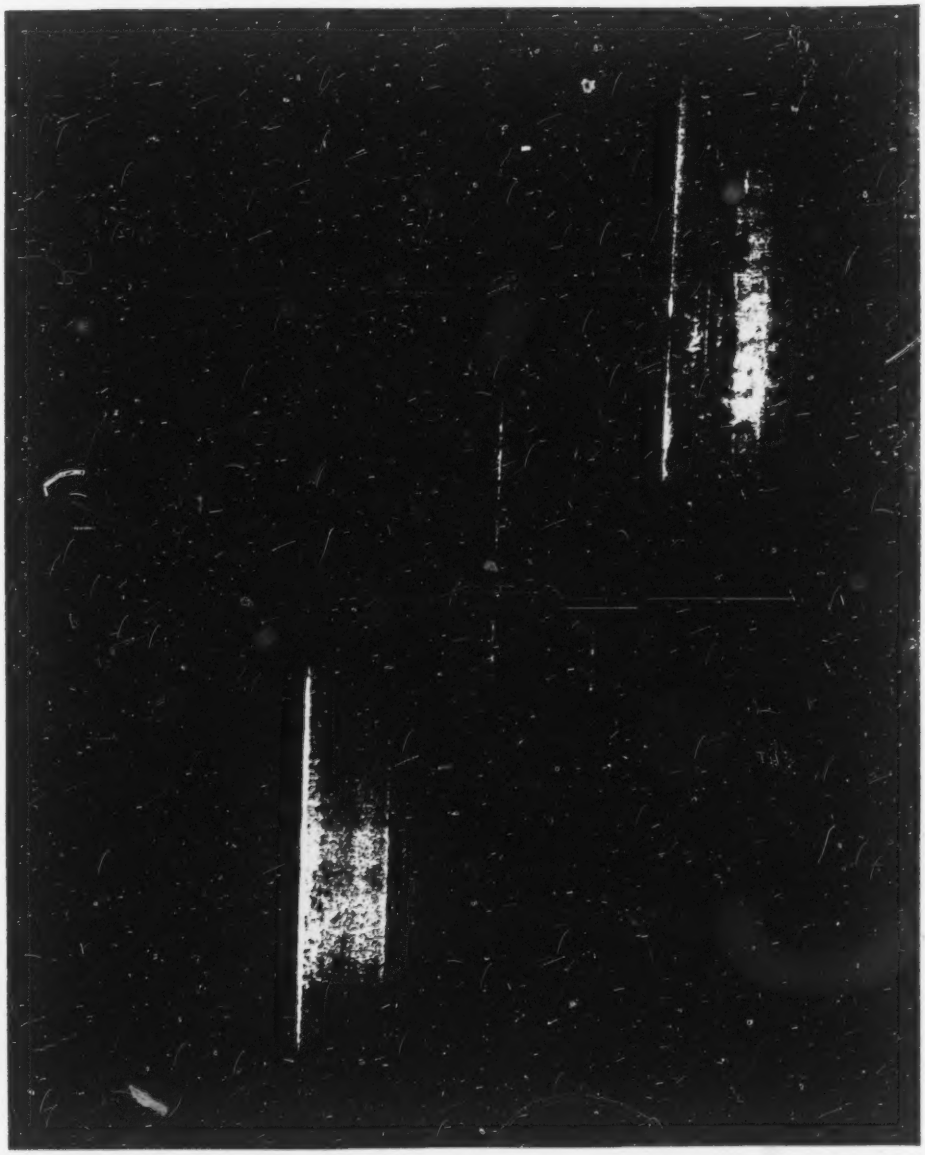


FIGURE 13 AFTER Page 25...



TEST SEVEN

80 GRIT SANDPAPER

METHOD:

Specimens A7, B7 and C7 were both stencilled and chemically etched with "Canada" on two sides. One side on each specimen was subjected to a vigorous rubbing with 80 grit sandpaper, on both the stencilled and chemically etched areas. They were rubbed until all indications were completely erased.

RESULTS AND OBSERVATIONS:

Specimen A7

Stencilled with paint and chemically etched, after thirty seconds of rubbing the stencilled portion of the specimen was erased completely. After forty seconds of rubbing, the etched portion of the specimen was erased completely.

Specimen B7

Stencilled with stain and chemically etched, after twenty seconds of rubbing the stencilled portion of the specimen was completely erased. The etched area was completely erased after forty seconds.

Specimen C7

Stencilled with printing ink and chemically etched, the stencilled portion of this specimen was completely removed after thirty seconds of rubbing. The etched section of the specimen was completely removed after thirty five seconds of rubbing.

FIGURE 14 BEFORE Page 27...

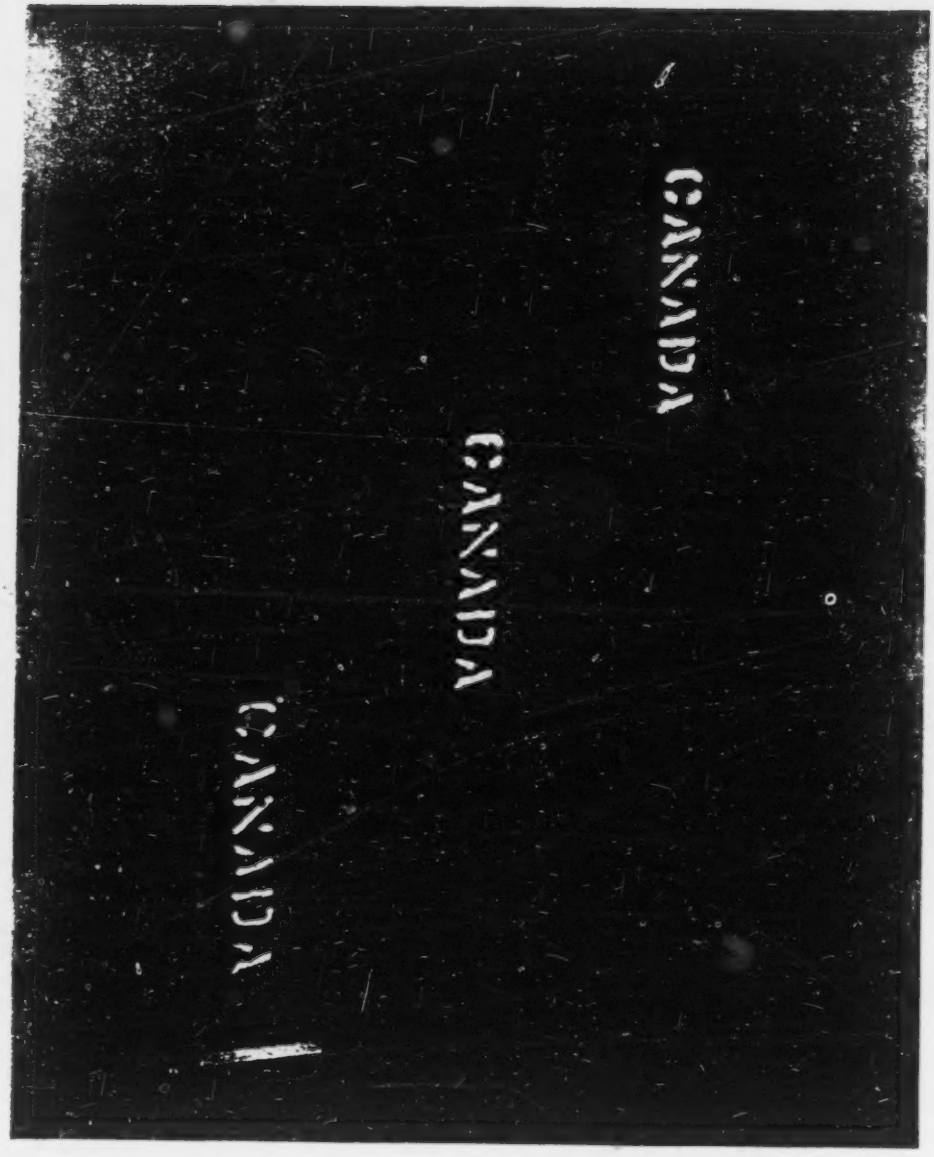
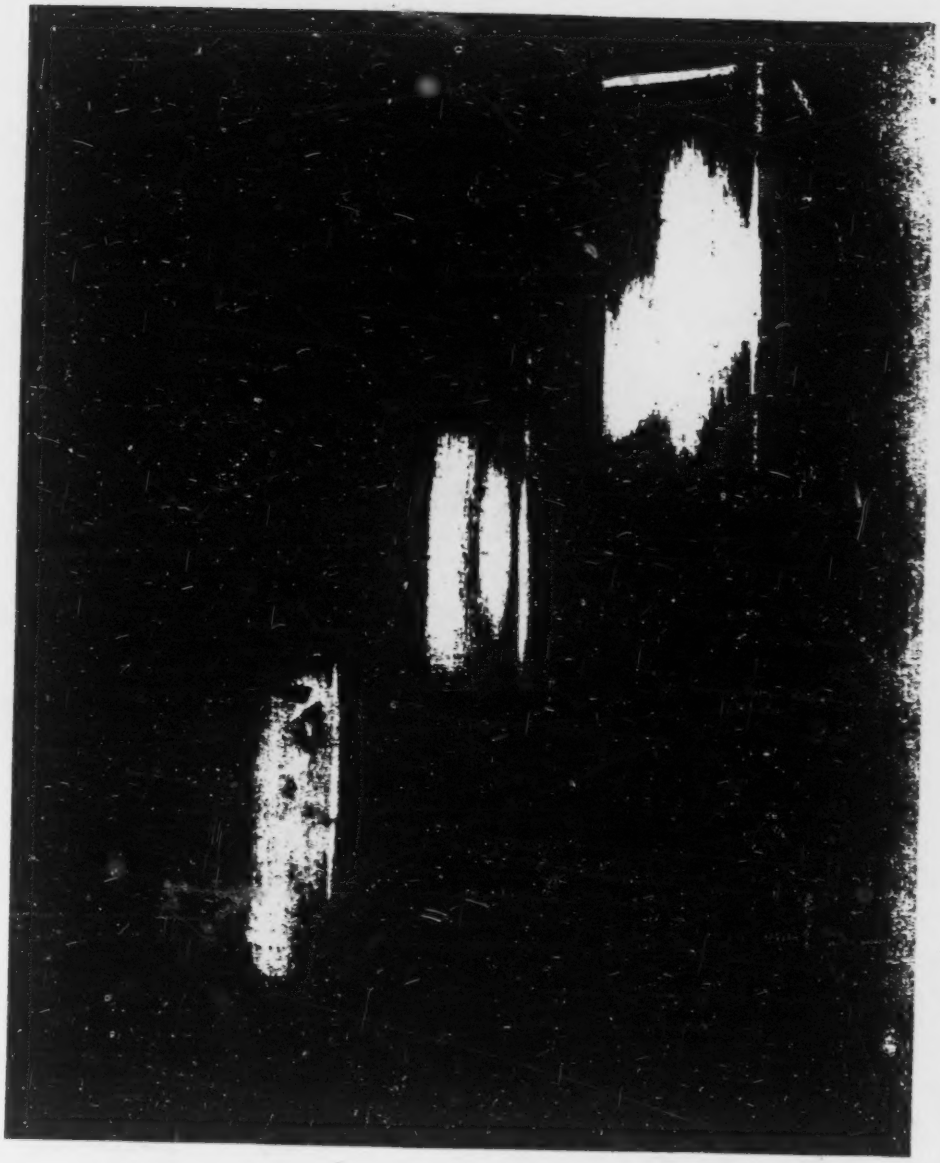


FIGURE 15 AFTER

Page 28...



CONCLUSIONS

The stencilled portion of both the corrosion test pieces stood up very well. Both specimens X and Y showed their protective qualities when exposed to a corrosive environment.

The stencilling on Specimen X (Accelerated Corrosion Test One) protected the surface under it sufficiently enough to actually leave the letters raised above the rest of the face. (REFER TO ACCELERATED CORROSION TEST PART ONE)

The etched portion was completely corroded from the face of the specimen.

Corrosion Test Two showed that stencilling's clarity and readability went virtually undisturbed after oxidation. The die-stamped and etched images were both significantly obscurred by the formation of oxides on the surface. (REFER TO ACCELERATED CORROSION TEST PART TWO)

The protective qualities of the inks and stains were further illustrated through the sulfamic acid test. Although the surface of the metal had been corroded until shiny, the stencilled letters remained clear and intact. (REFER TO TEST TWO)

CONCLUSIONS, CONT'D

The common industrial solvent easily removed the paint stencilling, but had little effect on the stain and ink stencilling, even after thirty minutes of rubbing. (REFER TO TEST FOUR)

Manufacturers of both the stain and the ink advise that their products have an etching quality if they are allowed to cure sufficently. From our experience in using the stain and ink, we have found this to be true. (An example of this etching quality can be seen on sample C-6.)

The specimens used in this testing were only allowed to cure for a twenty-four hour period. Although the specialized solvents successfully removed the stencilling, our experience shows us that the removal time would be substantially increased with an increased curing time.

Another factor affecting the penetrating qualities of the stain and ink is the porous nature of the specimen's surface. The more porous the surface the greater the penetration.

Once the stain or ink penetrates the surface and cures sufficiently, it becomes as permanent as a chemically etched image would be. (This can be seen in sample C-6.)

APPENDIX D

TELEPHONE 519-621-8191

ESTABLISHED 1929

The Galt Testing Laboratories Limited

CHEMISTS and METALLURGISTS

15 HIGHRIDGE COURT (AT PINEBUSH ROAD)
P.O. BOX 363
CAMBRIDGE (GALT), ONTARIO
N1R 7L3

Chemical Analyses of Malleable, Meehanite, Ductile and Cast Irons, Plain, Alloyed and Stainless Steels, Zinc and Aluminum Alloys, Brass and Bronze, Coal, Coke, Limestone, Slags, Etc.

Physical Analyses including Tensile, Yield, Elongation, Transverse, Rockwell, Brinell and Bend Tests, Microscopical, Graphite Flake Type, Photomicrographs, Impact Testing, Microhardness, Sand Testing

ASSOCIATED TUBE INDUSTRIES LIMITED

7455 Woodbine Avenue
MARKHAM, Ontario
L3R 1A7

Salt Spray Test of 3/4" X 0.035" Feedwater Heater Tube

Lab # P188-227-84

November 26, 1984

THE GALT TESTING LABORATORIES LTD.

PER: _____ Q.A.

PER: _____ SUPERVISOR

This report relates only to the particular instrument, material or other subject referred to in it. No representation is made that similar articles will be of like quality. Without the prior written consent of the Galt Testing Laboratories Limited, No publication in whole or in part of the text or substance of this report shall be made, nor shall the name of the Galt Testing Laboratories Limited be used in any way in connection with the sale, offering or advertising of any article or product. Any testing, inspection or investigation of the instruments, materials or other subjects performed by the Galt Testing Laboratories Limited will be conducted in accordance with the best technical standards by the Galt Testing Laboratories Limited but neither it nor its employees shall be responsible for any loss or damage resulting directly or indirectly from any default, error or omission.

The Galt Testing Laboratories Limited

Introduction

The following report covers the 72 hour salt spray testing of a four inch piece of 3/4" X 0.035" Feedwater Heater Tubing,sample number 1013. Testing was performed in accordance with ASTM B117-73.

Neutral Salt Spray Test

Purpose:	To evaluate the salt spray resistance of a sample of type 304 stainless steel tubing.
Apparatus:	Salt Spray Cabinet, ASTM B117
Procedure:	1) Arrange the tube in the salt spray cabinet as per ASTM B117-73 and expose to neutral salt spray. The orientation of the tube is such that the printed identification on the tube surface is facing the maximum flow of salt spray. 2) Once every 24 hours, examine the tube for signs of corrosion and monitor the air pressure and salt solution collection. Monitor the salt spray cabinet temperature twice every 24 hours. Record all results in the daily report sheets. 3) Remove the tube after 72 hours of exposure and examine for signs of corrosion.
Observations:	1) Daily report sheets are retained on file at Galt Testing Laboratories Limited. 2) After 72 hours of exposure to neutral salt spray, the tube exhibited red corrosion on the cut edge. Also, a slight orange-rust discolouration just above and between the lettering - '3/4"' and 'X' was apparent. The printed 'n' and 'e' in 'Woodbine' had faded slightly.
Conclusion:	1) Test pieces returned to customer for evaluation.

EXHIBIT II

DEERE & COMPANY

JOHN DEERE ROAD MOLINE, ILLINOIS 61265 U.S.A.

Tax Department

Commissioner of Customs
U. S. Customs Service
1301 Constitution Avenue, N. W.
Washington, DC 20229

Attention: Mr. John Simpson
Director: Office of Regulations & Rulings

Re: Country of Origin Marking of Pipe and Pipefittings of Iron or Steel:
19CFR Part 134

Dear Mr. Simpson:

On January 9, 1985 the Customs Service published a "Solicitation of Comments" in the Federal Register requesting public comments on those pipe and pipefittings of iron or steel that cannot be marked by means of die stamping, etching, engraving or cast-in-mold lettering for country of origin purposes as prescribed in Section 207 of the Trade and Tariff Act of 1984 without rendering such articles unfit for the purposes for which they were intended or violating industry standards for such articles. In response to that solicitation, Deere & Company, on February 22, 1985, submitted comments with regard to its importation of hollow tubing used in its safety bar "Roll-Over Protective Structure" (ROPS) mounted on farm

equipment and industrial machines. On February 25, the U. S. Customs Service drafted a consensus agreement on country of origin markings with regard to pipe, pipefittings and hollow mechanical tubing taking into account all of those cases whereby marking by the means prescribed in Section 207 of the Trade and Tariff Act would render the articles unfit for the purposes for which they were intended or would violate industry standards for such articles. Unfortunately, those guidelines do not cover the hollow tubing/ROPS safety bar problem discussed by Deere in its letter dated February 22, 1985.

In discussing this with members of the Department of Treasury and the U. S. Customs Service, it was suggested that an additional letter of information be submitted describing in detail the problems presented by the hollow mechanical tubing imported by Deere for the ROPS safety bar vis-a-vis Section 207 of the Trade and Tariff Act of 1984. This letter is in response to that request for additional information.

As set forth in our letter of February 22, Deere is the world's leading manufacturer of agricultural equipment. It is also a substantial manufacturer of industrial equipment and consumer products. In 1966, Deere developed a safety bar Roll-Over Protection System for the operators of farm machinery and industrial equipment. Since that point in time, Deere has been installing ROPS safety bars on its farm equipment and industrial machinery as an added safety feature of the equipment.

With the passage of the Williams-Steiger Occupational Safety and Health Act in 1970, roll-over protective structures became a required Federal safety feature on machines used in construction that were manufactured after 1969. The standards

set under this Act were administered by the Occupational Safety and Health Administration ("OSHA") under the U. S. Department of Labor. Since then, additional regulations governing ROPS have been passed by the Department of the Army, and the Department of the Interior Mining Safety and Health Administration.

Concomitantly with the requirement that ROPS safety bars be required under various federal safety and health standards, the specifications for the chemical and metallurgical composition of ROPS safety bars became subject to federal, as well as international and other independent industrial society, regulations. In fact, at present, John Deere certifies that its ROPS safety bars have been designed and manufactured in compliance with requirements and regulations issued by the American Society of Agricultural Engineers ("ASAE"), the Society of Automotive Engineers ("SAE"), the Occupational Safety and Health Administration ("OSHA"), and the Corps of Engineers. As set forth in the attached letter dated March 5, 1985 dealing with "ROPS CERTIFICATION", John Deere Product Engineering Center Engineers have certified that ROPS safety bars manufactured by John Deere have been designed and manufactured to the standards set forth therein as follows:

1. OSHA Requirements:

   (a) 29CFR Part 1928 Subpart C, and Par. 1928.51 - performance test of the structural integrity and impact resiliency of the ROPS safety bar.

   (b) 29CFR Paragraph 1926.1002 - ROPS safety

bar frame test procedures and performance requirements for agricultural equipment and industrial and construction machinery.

2. Independent Industry Standards:

(a) American Society of Agricultural Engineers - S383 Roll-Over Protective Structure (ROPS) For Wheeled Agricultural Tractors - energy absorption and impact energy testing requirements for ROPS safety bars.

(b) Society of Automotive Engineers - J1194 Roll-Over Protective Structure (ROPS) For Wheeled Agricultural Tractors - energy absorption and impact energy testing for ROPS safety bars. In addition, SAE J167, J231, J320a, J320b, J334a, J394,J394a, J396, J396a, J1040, J1040a, J1040b, and J1040c, provide test procedures and performance requirements and criteria for ROPS safety bars on various industrial machinery.

3. Organization for Economic Cooperation and Development ("OECD") - C(83)83 (FINAL) Annex III - OECD Standard Code for the official Testing of Protective Structures Mounted on Agricultural Tractors -performance testing and energy absorption and impact energy testing of ROPS safety bars developed for the International Trade Association.

4. Corps of Engineers - Department of the Army Manual: EM385-1-1; Item 18.A.20 ROPS Requirements.

As you can see, because of the nature of the product - a safety bar Roll-Over Protection System - the design and manufacture is closely regulated to provide the optimum level of safety and protection possible. In addition, the mechanical hollow tubing that Deere imports for use in its ROPS safety bar is manufactured to specific John Deere chemical and metalurgical requirements. Thus, that structural hollow tubing is not a common industry standard but, rather, specifically manufactured to the specifications of John Deere such that after processing by Deere into its finished product, it may be certified to meet all the above Federal regulations and industry standards.

Moreover, the structural integrity, the energy absorption qualifies, and the impact energy qualities of this tubing is essential to the finished product. Because of the importance of the structural soundness of the hollow mechanical tubing, it is imperative that any hazards to the structural integrity be avoided. Marking the tubing with the proper country of origin by the methods prescribed by the Trade and Tarrif Act - die stamping, cast-in-mold lettering, etching or engraving - would cause internal damage to the composition of the hollow mechanical tubing such that the structural integrity of the ROPS safety bar would no longer be adequate to meet the requirements of the federal, international and independent agency regulations. Further, any of the four prescribed methods of marking may create weakness in the metal that may permit "stress risers" to appear and make the metal more prone to both cracking and breaking . More importantly, marking the tubing in the manner prescribed by the Act would create

untold safety risks resulting in an unreliable product that would affect customers lives. Thus, to mark the hollow mechanical tubing by the four prescribed methods of the Trade and Tariff Act of 1984 would render the tubing unfit for use in a ROPS safety bar and violate both Federal and industry standards for structural integrity as well.

As a result, Deere hereby requests that the U. S. Customs Service amend its consensus agreement on country of origin marking by permitting a permenant exemption from the four prescribed marking methods of the Trade and Tariff Act for hollow mechanical tubing used in ROPS safety bar manufacturing because the statutory methods would substantially diminish or destroy the utility of the tubing. In lieu of the four prescribed statutory methods, such tubing could be marked by paint stenciling or tagging.

Further, Deere imports the hollow mechanical tubing for the ROPS safety bar process from foreign sources because it is not possible to find a domestic source that can provide the same hollow tubing with the same degree of structural integrity necessary for certification. Accordingly, Deere is forced to go into the foreign marketplace for this hollow mechanical tubing and thus cannot avoid the perils of the statutory prescribed marking methods by reverting to a domestic producer. Thus, since there is no domestic source of goods for the ROPS processing, the Customs Service must provide an alternative to the four prescribed statutory methods of marking to avoid any risk to the structural soundness and integrity of the tubing used for the ROPS safety bar process.

In summary, the hollow mechanical tubing imported by Deere to be used in its ROPS safety bar processing is subject to certification for structural soundness and

integrity, as well as impact and energy performance testing, under regulations administered by OSHA, the American Society of Agricultural Engineers, the Society of Automotive Engineers, and the Organization for Economic Cooperation and Development. Because of the importance of the structural soundness and integrity of that hollow mechanical tubing, marking by any of the four prescribed statutory methods would endanger the structural integrity and soundness such that the hollow tubing would be unfit for its intended purpose and would violate not only industry but independent and international standards for such tubing, as well. Accordingly, Deere hereby requests that the guidelines to be issued by the Customs Service include a provision allowing hollow mechanical tubing used for ROPS safety bar processing to be marked by paint stenciling or tagging.

Should you need any further information in order to grant the exemption requested, please contact me at Deere & Company, c/o Tax Department, John Deere Road, Moline, Illinois 61265 or 309-752-4069.

Very truly yours,

Joseph P. Cravero

Senior Tax Attorney

JPC/vj

Enclosure

c: Robert R. Newcomb

Deputy (Regulatory Trade and Tariff Affairs)

To the Assistant Secretary for Enforcement

and Operations

Department of Treasury

15th and Pennsylvania N. W.

Room 4313

Washington, DC 20220

C. J. Ehlert

EXHIBIT III

DOW, LOHNES & ALBERTSON

1255 TWENTY-THIRD STREET

WASHINGTON, D. C. 20037

TELEPHONE (202) 857-2500

TELECOPIER (202) 659-0059

CABLE "DOWLA"

TELEX 403946

WRITER'S DIRECT DIAL NO.

(202) 857-2566

May 15, 1985

BY HAND

George J. Weise, Esq.
Professional Staff Member
House Ways and Means
Subcommittee on Trade
Longworth House Office Building
Room 1111
Washington, D.C. 20515

Re: Country of Origin Pipe and Tube Marking

Dear Mr. Weise:

Thank you for giving the Canadian Tubular Producers Association (the "CTPA") the opportunity to comment upon the position of the American Iron and Steel Institute (the "AISI") on Section 224 of the Technical Corrections Act of 1985 (H.R. 1800), which would amend Section 207 of the Trade and Tariff Act of 1984. It is the CTPA's understanding that the AISI would like to modify Section 224 to (1) provide that in the case of small-diameter pipe and tube the bundles or containers would be tagged in a manner consistent with applicable standards, and (2) provide that where stenciling is permitted, that it be continuous stenciling. The CTPA agrees to the first, but opposes the second modification.

This document is submitted by Dow, Lohnes & Albertson, which is duly registered under the Foreign Agents Registration Act of 1938, as amended, as an agent of the Canadian Tubular Producers Association.

With regard to tagging, the CTPA does not object to modifying Section 224 so that tagging would be permitted in accordance with industry standards, such as those issued by the American Society for Testing and Materials (the "ASTM") or the American Petroleum Institute (the "API"). The CTPA, however, wishes to emphasize that it supports the tagging of bundles only and that sub-bundles should not have to be individually tagged. Note that with regard to pipe size, number of pieces and weight per sub-bundle, Table 5 of ASTM A700 (which is entitled "Standard Practices for Packing, Marking, and Loading Methods for Steel Products for Domestic Shipment") provides that: "Other bundling practices may be available, subject to agreement between the purchaser and the manufacturer."

Finally, the CTPA disagrees with the AISI's statement that all bundles are broken before the pipe reaches its ultimate consumer. A significant portion of the pipe sold in bundles by the CTPA's members is sold directly to the ultimate consumer and must comply with the consumer's own rigorous packing and labeling instructions.

With regard to stenciling, it is the CTPA's understanding that the AISI wants continuous stenciling because single-mark stenciling is not as permanent as die stamping, etching or engraving. This is not correct; stenciling is as permanent, if not more permanent, than these marking methods. This was amply demonstrated at the January 24, 1985 meeting between representatives of the CTPA and certain Congressional staff members. At this meeting, we presented the following information:

(1) A test report on the permanency of stenciling (a copy of which is enclosed).

(2) Samples of pipes on which the stencil had survived subsequent heat treatment, which had obliterated allowable die stamps.

(3) Photographs of Canadian pipe that had been stored for several years outdoors and upon which the stencil was still clear.

(4) A discussion of the fact that in order to maintain minimum wall thickness requirements for certain pipes, the die stamp, etching or engraving would have to be so shallow that it would be almost invisible and would quickly disappear from corrosion in a short time.

In addition, the current method of continuous stenciling would result in a less legible and an inferior mark as compared to single-mark stenciling. Continuous stenciling is accomplished by the pipe running against a movable bicycle paint wheel. Because this process may result in gaps, smears and uneven paint application, the marking is not as legible and may not be as permanent as a single-mark stenciling. Furthermore, continuous stenciling would interfere with current practices and standards for the marking of the pipe with various types of product information.

The AISI premises its call for continuous stenciling on an inflated threat of fraudulent marking. It is estimated that only 20 percent of the pipe entering the United States would be eligible for stenciling. About half of that amount would be oil country tubular goods, which are normally sold through only one intermediary to the ultimate consumer and which are not subject to multing (i.e., being cut into small lengths). Consequently, only about 10 percent of total U.S. pipe imports might be subject to the fraudulent practices alleged by the AISI. The AISI, however, would require that a foreign manufacturer incur substantial costs in equipment, engineering and installation per mill in order to continuous stencil its pipe. This would be in addition to any expenditures on die stamping, etching or engraving facilities. Given that each manufacturer may have four to five mills, continuous stenciling would impose a substantial financial burden on the manufacturer in order to protect a small percentage of U.S. pipe imports from the possibility of fraudulent practices.

Finally, continuous stenciling would be impractical for many manufacturers. For example, for many continuous-weld pipe mills, the pipe would have to be stenciled off-line after cooling. In addition, for mills that produce non-standard size pipes, stenciling is often by hand; consequently, continuous stenciling would be a more costly and laborious task than single-mark stenciling.

In conclusion, the CTPA does not oppose modifying Section 224, or clarifying the accompanying conference report, to permit tagging of bundles only in accordance with applicable industry standards. The CTPA, however, does oppose any modification that would require continuous, instead of single-mark, stenciling. Stenciling is just as permanent, if not more so, than die stamping, etching or

George J. Weise, Esq.
May 15, 1985
Page 4

engraving. If you have any questions or need additional information, please contact me, William Silverman or John C. Jost of this law firm.

Sincerely,

Kenneth D. Salomon
Attorney for the Canadian
Tubular Producers Association

KDS:rj
Enclosure

cc: Janet Nuzum, Esq. (w/enclosure)

[EDITOR'S NOTE: The remainder of Exhibit III is a repeat of the material contained in appendix C, and is not printed here.]

STATEMENT OF CAPITAL HOLDING CORP.

TREATMENT OF CERTAIN DEBT INSTRUMENT PURCHASES AS LOANS UNDER SECTION 815

The proposed Technical Corrections Act of 1985 (introduced as H.R. 1800 and S. 814) would amend section 815 of the Code to clarify that a bona fide loan cannot constitute a distribution within the meaning of that provision. This amendment is necessary because of the facts recounted below, and, as will be explained, it is also necessary to extend its scope to cover purchases of mandatorily redeemable preferred stock.

Under section 815 of the Code as revised by the Tax Reform Act of 1984, distributions to the shareholders of a stock life insurance company are considered to be made from the company's "shareholders surplus account" (with no immediate tax consequence to the company) or from its "policyholders surplus account" (triggering the so-called phase III tax) whether those distributions are made in the form of direct payments or in a more indirect form. This generally preserves, and yet expands somewhat, the rules of section 815 under prior law. See H.R. Rep. No. 432, Pt. 2, 98th Cong., 2d Sess. 1410–1411 (1984); S. Prt. No. 169, Vol. 1, 98th Cong., 2d Sess. 536 (1984); Staff of the Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* 594 (1984) (the "Blue Book").

The direct distributions to which new section 815 refers clearly are those encompassed by the prior law rules, such as the typical corporate dividend and (as former section 815(f) expressly provided) a distribution in redemption of stock. The new statute's reference to indirect distributions, on the other hand, represents an addition to the phase III rules to make it clear that distributions made to others for the benefit of shareholders (as well as those made directly to shareholders) are counted as disbursements from the phase III accounts. An oft-cited example of such an indirect distribution is a subsidiary's purchase of its parent's stock from one of the parent's shareholders, which section 304 of the Code treats as a distribution in redemption of stock. The Tax Court found such a transaction to be a distribution within the meaning of former section 815 in *Union Bankers Insurance Company* v. *Commissioner*, 64 T.C. 807 (1975). As the committee reports accompanying the 1984 Act explained: "The bill provides that any direct or indirect distribution to shareholders from an existing policyholders surplus account of a stock life insurance company will be subject to tax at the corporate rate in the taxable year of the distribution. For these purposes, the term distribution is intended to include actual and constructive distributions. See *Union Bankers Insurance Co. . . . .*" H.R. Rep. No. 432, *supra;* S. Prt. No. 169, *supra.*

The Blue Book, however, went considerably beyond this in its commentary on indirect distributions under new section 815: "The citation to *Union Bankers Insurance Co.* indicates the type of fact situations in which liability for a phase III tax could arise . . . There would be an indirect distribution [from the policyholders surplus account] . . . whenever policyholders surplus account funds are used to benefit the shareholders indirectly (for example, by having the stock life insurance company purchase the parent's stock either from the parent or a shareholder of the parent, or by having the company make loans to the parent whether or not for adequate consideration)."

The Blue Book's reference to inter-corporate loans, and its conclusion that they should be treated as section 815 distributions, had no precedent in the language or legislative history of the 1984 Act, let alone in the provisions or interpretations of the prior law which new section 815 generally preserved. See, e.g., PLR 8033102; PLR 7848006. The same was true of inter-corporate purchases of mandatorily redeemable preferred stock. See, e.g., PLR 8515017 (1984 Act).

While the treatment of purported loans as distributions is understandable where they do not constitute true indebtedness (as where there is no intention to obtain repayment or no compensation for the time value of money), such treatment of bona fide loans is unwarranted. Loans to affiliates that have the characteristics of arms-length indebtedness—those that are documented, repayable, and compensated in the same manner as borrowing between non-affiliated entities—constitute legitimate investments of the lending party and, with respect to the borrowing party, provide no benefit akin to an ownership distribution. In case of a life insurance company in particular, it is to be expected that the company (acting in its role as a financial intermediary) will seek to make bona fide loans to earn a return on its financial assets. And it should not be surprising that a company will make such loans to its affiliates, for its own convenience and security as well as that of the affiliated group; indeed, such loans are commonplace.

Recognizing this, section 121(j) of the proposed Technical Corrections Act would add a new sentence at the end of section 815(a), which would state: "For purposes of the preceding sentence, the term 'indirect distribution' shall not include any bona fide loan with arms-length terms and conditions." The Treasury Department, in its testimony before the Ways and Means Committee at the May 16, 1985 hearing on the proposed Act, indicated its support for this clarifying amendment.

This proposed change, as far as it goes, is entirely meritorious and should be adopted. It should also be extended, however, to bring manditorily redeemable preferred stock within its ambit. Such stock is more closely akin to debt than to equity, and a life insurance company's purchase of such stock issued by an affiliate, like its grant of a bona fide loan to the affiliate, should not give rise to a constructive "indirect distribution" under section 815. This becomes clear when the characteristics of such stock are examined:

Like a bona fide loan, mandatorily redeemable preferred stock provides its holder with the issuer's unconditional promise to pay a principal sum certain on or before a fixed maturity date.

Like indebtedness, the final payment date is not unreasonably far in the future, typically not beyond 20 or 30 years after the stock was issued.

Unlike equity interests, the stock is typically redeemable by means of a sinking fund arrangement, with ratable redemptions each year beginning on a future date (such as after 5 or 10 years beyond the issue date) and ending with the maturity date.

Also unlike equity interests generally, the stock does not entitle its holder to voting rights (except for limited rights which only become available under circumstances amounting to default), and it grants the holder no pre-emptive rights to subscribe to future equity issues.

In light of these characteristics, the purchase of mandatorily redeemable preferred stock is, from the perspective of the purchaser, tantamount to the grant of a long-term loan to the stock's issuer. It therefore should be treated, from the standpoint of section 815, in the same manner as a direct loan.

The Internal Revenue Service recently recognized as much in a private ruling issued under the 1984 Act. In that ruling, the Service held that a life insurance company's acquisition of preferred stock of its parent that was mandatorily redeemable (with ratable redemptions, on a sinking fund basis, beginning after 5 years beyond the issue date and continuing for the next 25 years) did not give rise to a distribution under section 815. *See* PLR 8515017.

To confirm this treatment of mandatorily redeemable preferred stock, the following italicized phrase should be added to the sentence that section 121(j) of the proposed Act would include in section 815(a): "For purposes of the preceding sentence, the term 'indirect distribution' shall not include any bona fide loan with arms-length terms and conditions *or any transaction which involves the purchase of stock by the life insurance company that is preferred as to dividends and mandatorily redeemable by the issuer.*"

Statement of Caterpillar Tractor Co.

Caterpillar Tractor Co. would like to comment on the Technical Corrections Act of 1985. We recommend that the Committee complete the process it began last year and enact legislation regarding Export Trade Corporations (ETCs) that were not subject to the provisions of the Deficit Reduction Act.

Specifically, we urge the Committee to include former Export Trade Corps. in the 1984 tax treatment accorded present ETCs. This action would take into account the exporting that former ETCs—just like ETCs—are engaged in. Congress has not provided a method for former ETCs to terminate in an orderly fashion. We feel that it is highly appropriate for Congress to provide a termination mechanism for former ETCs—as outlined in this statement—similar to the ETC provisions in the 1984 legislation.

The Deficit Reduction Act of 1984 included important new provisions establishing Foreign Sales Corporations (FSCs). The FSC provisions were passed at the administration's request and with the full support of the business community. The FSC was designed by the U.S. Trade Representative and Treasury Department to meet trading partners' complaints against the provisions permitting Domestic International Sales Corps. (DISCs). Last year, for large exporters, Congress effectively repealed the decade-old DISC statute and replaced it with a GATT-legal Foreign Sales Corp. export incentive. Both the DISC and the FSC were designed to encourage U.S. ex-

ports and to partially offset the more favorable tax treatment accorded exports by the European community.

In the process of drawing up legislation to convert DISCs to FSCs, Congress also partially addressed the issue of Export Trade Corporations. While no new companies can now qualify for ETC benefits, Export Trade Corp. provisions have been in the tax code for decades. Companies that established ETCs found that their ETCs had to meet several standards. At least 90% of the ETC's income must have been generated outside of the United States and, of this, 75% had to be derived from U.S. exports. ETCs that failed to continue to meet these tests, however, did not forfeit the right to continue to retain deferred income. Under the present law, companies can retain their former ETCs and the corresponding deferral on previously-earned export income if such income is invested in certain qualified export assets. In a case where an ETC fails to meet the income test but can still meet the asset test, no additional new income can be deferred.

It should be pointed out that the tax laws have always treated ETCs and DISCs somewhat differently in an important way. DISCs that failed to meet all of the standards in the law immediately became subject to taxation. In other words, a DISC received favorable tax treatment only so long as it operated fully as a DISC. On the other hand, former ETCs have no termination point if they do not meet income tests. Only if asset tests are also not met would an ETC become subject to full taxation.

Additionally, Congress has not provided for all ETCs the type of phase-out mechanism it provided for DISCs last year. Some ETCs were allowed permanent tax forgiveness if they currently qualified as ETCs that met all of the income and asset tests. Active former ETCs (then falling short of the income source requirements) were given no options but continued status as a former ETC.

Consequently, last year's tax legislation did not deal comprehensively with ETCs. Rather, it focused only on those ETCs that then fully met the income standards requirement. Other ETCs that had fallen short of the income standards—but which still met the assets standards—were not covered by the 1984 legislation. The consequence of the 1984 law is that former ETCs which in 1984 were not qualified for new tax deferrals—based on the two income source tests—are left in tax limbo.

These particular ETCs are still generating exports just like the ETCs which meet the income standards. They would virtually have to do so. Otherwise they would not meet the assets test. They are, however, not generating the exact level of exports specified in the law.

Caterpillar has for decades had two (now former) export trade corporations because the company is one of the largest U.S. exporters. These companies ceased to meet the income standards many years ago but have always met the assets test. Each year the company must show to the IRS that its assets on the last day of the taxable year meet the legal requirements. As long as that is satisfied, taxes on the ETC are deferred indefinitely. In our view, this amounts to an annual paperwork and accounting burden that serves no useful purpose in light of last years' tax law changes for other ETCs.

The question we would pose to the committee is this: why should some ETCs be considered as previously taxed—as Congress did in 1984—while not offering the same treatment to the Caterpillar-type ETC? We do not see a logical reason for excluding some ETCs from the 1984 tax treatment. Extending the 1984 forgiveness to them would clean up what has become essentially a deadwood provision of the tax law.

We feel it is appropriate to address the remaining ETCs in the framework of the Technical Corrections Act of 1985. An amendment accomplishing this task is attached. Caterpillar Tractor Co. urges the Committee to add language to this effect.

A BILL To provide relief for former export trade corporations

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That—

(a) SPECIAL RULE FOR FORMER EXPORT TRADE CORPORATIONS.—

(1) IN GENERAL.—If, before January 1, 1986, any former export trade corporation elects the benefits of this Act then any previously excluded export trade income which is derived before January 1, 1986, shall be treated as amounts included in gross income for a prior taxable year (within the meaning of section 970(b)(2) of the Internal Revenue Code of 1954).

(2) ELECTIONS.—Any election made under this Act shall be made at such time and in such manner as the Secretary of the Treasury or his delegate may prescribe.

(3) FORMER EXPORT TRADE CORPORATION.—For purposes of this Act, the term "former export trade corporation" means any corporation which satisfied the requirements of Section 971 of the Internal Revenue Code of 1954 for one or more prior taxable years, but did not satisfy the requirements of Section 971 for the most recent taxable year ended prior to the date of enactment of the Deficit Reduction Act of 1984.

(b) EFFECTIVE DATE.—The amendments made by section (a) shall apply to taxable years ending after the date of enactment.

LAW OFFICES OF GROOM & NORDBERG,
Washington, DC, May 28, 1985.

Re May 16, 1985 Hearing on technical corrections: Comments on H.R. 2110 on behalf of Chevron Corp.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means, House of Representatives, Washington, DC.

DEAR MR. CHAIRMAN: These comments on H.R. 2110, a bill to make technical corrections to the Retirement Equity Act, are submitted on behalf of Chevron Corporation ("Chevron"). Chevron and its affiliates (including Gulf Oil Corporation) currently maintain tax-qualified plans for the benefit of over 90,000 employees, former employees, and their beneficiaries.

Our comments may be briefly summarized as follows:

1. Where an alternate payee is entitled to benefits under a qualified domestic relations order ("QDRO"), plans should be permitted to distribute benefits at any time without adversely affecting their tax-qualified status if the plan provides for, and the alternate payee consents to, the distribution.

2. The relationship between the survivor benefit rules and the QDRO provisions should be clarified by statute. In particular, it should be confirmed that the joint and survivor rules, and the related requirement for exempted plans that 100 percent of the account balance be payable upon the participant's death to the surviving spouse, do not apply to the extent benefits have been assigned to an alternate payee by a QDRO.

3. It should be confirmed that, should an alternate payee choose to receive benefits where the participant continues working and is not fully vested, the plan is not required to increase benefits to the alternate payee to reflect subsequent vesting by the participant.

4. The Federal income and gift tax consequences of spousal waivers of benefits should be clarified.

5. The expanded spousal consent rules should also be clarified, particularly (1) with respect to the requirement that consent apply to a specific beneficiary and (2) to deal with plans which generally do not provide for payments to other beneficiaries where the spouse consents to waive survivor coverage.

6. The transition rule to avoid double death benefits should be revised or eliminated, to remove any implication that double benefits are required outside the scope of the rule.

7. The tax consequences of QDRO payments to alternate payees other than former spouses should be clarified.

These comments are set forth more fully below.

1. Where the alternate payee consents and the plan so provides, plans should be permitted to cash-out or commence benefits under a QDRO at any time, and unilateral cash-outs of small benefits should be permitted.

Sections 104 and 204 of the Retirement Equity Act provide an exception to ERISA's assignment, alienation, and preemption provisions for the payment of plan benefits to an alternate payee pursuant to a qualified domestic relations order ("QDRO"). The basic purpose of these provisions was to allow state courts to divide benefits in connection with divorce, subject to certain safeguards designed primarily to minimize the burdens and potential liabilities of plans and plan administrators. One such safeguard prevents a state court from ordering a plan to commence payments to an alternate payee prior to the date the participant attains or would have attained the plan's earliest retirement age. Code §§ 414(p)(3) and (4). In our view, this safeguard by itself does not limit a plan's ability, if it so desires, to commence payments at an earlier date.

There are general restrictions under Code sections 401(a) and 401(k), which apply to some but not all tax-qualified retirement plans, on the payment of benefits prior

to termination of employment.[1] The last sentence in Code section 414(p)(5) states that these restrictions do not apply to payments to an alternate payee "pursuant to a qualified domestic relations order." While we believe that this sentence was intended broadly to avoid any violation of sections 401(a) and 401(k) where payments are made to an alternate payee, the sentence could be read to avoid a violation only where the QDRO itself specifically authorizes the payment at that time.

Section 2(c)(4)(A)(v) of H.R. 2110 is intended to address the extent to which the sections 401(a) and 401(k) restrictions apply to payments to an alternate payee prior to any date specifically set forth in the QDRO. The proposed solution is that the restrictions would apply unless the present value of such payments does not exceed $3,500. As presently worded, the restrictions would not be waived for larger amounts, even if immediate payment is desired by the alternate payee.

In testimony before the Ways and Means Committee on May 16, the Treasury Department suggested that the issue of whether payments may be made to an alternate payee before the participant terminates employment should not be decided on the basis of the present value of the payments. We agree. We also agree that divorce "effectively severs" the link between the alternate payee and the employer maintaining the plan, and "thus may be seen as functionally equivalent to a participant's separation from service."

In our view, the proposed sweeping restriction on payments to alternate payees is contrary to the intent of the Retirement Equity Act. It was in recognition of the possible need of a divorced spouse for immediate funds that the "earliest retirement age" exception was added. Because the exception allows a court to order payments to an alternate payee even if not provided for under the plan, the condition that the participant attain the earliest retirement age was added to minimize the administrative burdens placed on plans. Where a plan and the alternate payee both desire earlier payments, we believe the statutory purpose is further served by facilitating, rather than prohibiting, such payments.

We recommend that this distribution of benefits issue be resolved in a manner which reasonably accommodates the needs of divorced spouses and the administrative problems of plan administrators. In the case of surviving spouses of deceased participants, the solution adopted by the Retirement Equity Act to balance these needs and problems is a $3,500 rule: benefits with a present value greater than $3,500 may be cashed-out only with consent, and benefits with a present value not greater than $3,500 may be cashed-out at the plan's discretion. We believe that similar rules should apply to surviving spouses and divorced spouses, and that the $3,500 compromise of the Retirement Equity Act should be extended to divorced spouses.[2]

To summarize our views on this issue, we recommend that H.R. 2110 be revised to provide as follows:

1. The restrictions under Code sections 401(a) and 401(k) regarding the payment of benefits prior to the termination of employment do not apply to payments to an alternate payee under a QDRO, regardless of when made, if the plan provides for such payments.

2. Where the present value of payments to the alternate payee exceeds $3,500, such payments may be cashed-out only with the consent of the alternate payee.

3. Where such present value does not exceed $3,500, payments may be cashed-out at the discretion of the plan administrator.

4. Present value should be determined as of the date of receipt of the QDRO by the plan.

We note two differences between our recommendations above and the testimony of the Treasury Department. First, we urge that the administrative costs and burdens created by small benefits be recognized, and that the $3,500 cash-out rule of the Retirement Equity Act be expanded to include QDRO payments. Second, the Treasury statement seems to suggest that the Code sections 401(a) and 401(k) restrictions would not apply only where the QDRO itself authorizes payments prior to the termination of employment. In that event, because a QDRO may not order pay-

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[1] Regulation section 1.401-1(b)(1)(i) has been interpreted to prohibit a defined benefit or money purchase pension plan from making in-service distributions prior to a participant's attaining normal retirement age. See T.I.R. 1403, Q&A M-15; IRS Letter Ruling 8453082 (Oct. 3, 1984). Code section 401(k)(2)(B) generally prohibits a qualified cash or deferred arrangement, which may be part of a profit-sharing or stock bonus plan, from making in-service distributions prior to a participant's attaining age 59½.

[2] Code § 417(e). While we believe that similar rules should apply to surviving spouses and divorced spouses, we would emphasize that there is an urgent need for clarification of the scope of Code section 417(e) and the related rules of Code section 411(a)(11).

ments to be made prior to the participant's attainment of the earliest retirement age, payments to the alternate payee prior to that time might violate sections 401(a) or 401(k) if the participant remains in service.

These apparent limitations fail to recognize that the policy underlying the cash-out rules applies whenever a plan is confronted with the task of accounting for benefits, particularly small benefits, with respect to individuals who are no longer connected with the employer or the plan. Specifically, the cash-out rules recognize that it may be exceedingly difficult for plans to maintain current information regarding the whereabouts of such persons. This problem is particularly acute for defined contribution plans that provide for directed investments and where there may be a need for regular contact with alternate payees with respect to investment matters. We would emphasize also that rules which provide plans with reasonable flexibility to deal with these problems through cash-outs will not prevent alternate payees from preserving their funds for retirement purposes, because (1) Code section 402(a)(6)(F) expressly allows tax-free rollovers of amounts received under QDROs and (2) plan administrators are required under Code section 402(f) to notify recipients of opportunities to make such rollovers. Accordingly, we believe that the sections 401(a) and 401(k) restrictions should not apply to QDRO payments whenever made, and that the divorced spouse's interests are adequately protected if written consent is required to cash out benefits exceeding $3,500.

2. The relationship between the survivor benefit requirements and QDROs should be confirmed in the statute.

Sections 103 and 203 of the Retirement Equity Act generally require that a preretirement or post-retirement survivor annuity be paid to the spouse of a deceased vested participant, unless the spouse consents in writing to waive the benefit. Certain profit-sharing and stock bonus plans are generally exempted from these survivor benefit requirements, but only if 100 percent of the account balance will be paid to the surviving spouse upon the participant's death (unless the spouse consents otherwise).

One very important question in this area is as follows. Where a QDRO assigns a portion of a participant's accrued benefit to a divorced spouse or other alternate payee, and the participant remarries and then dies, are the benefits assigned by the QDRO to the first divorced spouse excluded for purpose of computing the survivor benefits payable to the second spouse? Although the statute does not address this important issue, we think the legislative history makes it clear that a plan is not required to pay the same benefit twice, i.e., to both spouses. The final Senate Report on the Retirement Equity Act states that: "This rule [presumably referring to the general joint and survivor rules] does not apply, however, if a qualified domestic relations order . . . otherwise provides for the division or payment of the participant's retirement benefits. For example, a qualified domestic relations order could provide that the former spouse is not entitled to any survivor benefits under the Plan."

S. Rep. No. 575, 98th Cong., 2d Sess 16 (Aug. 6, 1984). Similarly, the helpful examples provided by House Education and Labor Committee Chairman Clay during the final House debate on the Retirement Equity Act specifically indicated how portions of the participant's accrued benefit would be converted into payments to a divorced spouse and a surviving spouse in this situation. See 130 Cong. Rec. H8761–62 (Aug. 9, 1984).

Although it was clearly contemplated that a plan would not have to pay the same benefit to both the divorced spouse and the surviving spouse, there is no explicit "carve out" in the survivor benefit rules for benefits previously assigned under a QDRO. Moreover, in the case of an exempt profit-sharing or stock bonus plan that generally provides 100 percent of the account balance to the surviving spouse in the event of death, there is no specific statutory provision that benefits need not be paid to the surviving spouse to the extent previously assigned to an alternate payee under a QDRO. In this regard, we are very concerned that courts might interpret the foregoing legislative history as applying only to those plans which are generally subject to the joint and survivor rules, and not to individual account plans which are exempt from such rules pursuant to Code section 401(a)(11)(B)(iii).

We believe these extremely important issues merit statutory confirmation. Otherwise, surviving spouses may assert that they have a statutory right to unreduced benefits, and plans will be in danger of having to make double payments.

3. Where an alternate payee chooses to receive benefits while the participant continues working and is not fully vested, it should be confirmed that the plan is not required to increase benefits to the alternate payee to reflect subsequent vesting.

In some cases a participant will not be fully vested upon reaching a plan's earliest retirement age (within the meaning of Code section 414(p)(4)(B)). A divorced spouse may nevertheless wish to receive benefits beginning at that date, rather than wait

until the participant may become fully vested, and a QDRO may provide for such earlier receipt of benefits.

Section 414(p)(4)(A)(ii) indicates that, where the alternate payee chooses to receive benefits before the participant terminates plan participation, the alternate payee's entitlement is based on the benefits accrued as of the date on which payment is to begin under the QDRO. We request confirmation that, in such cases, the plan is not required to provide increased or additional benefits to the alternate payee whenever the participant's vesting percentage increases. This is consistent with the initial report of the Senate Finance Committee on the Retirement Equity Act: "The special rule provides that in the case of a participant who has attained the earliest retirement age applicable to the participant under a plan, an order will not fail to be a qualified order merely because it requires a plan to pay benefits to an alternate payee in an amount determined as if the participant had retired at that time. Accordingly, the benefit payable to the alternate payee would not reflect subsequent benefit accruals or vesting by the participant."

S. Rep. No. 285, 98th Cong., 1st Sess. 19 (Oct. 29, 1983). To our knowledge, this vesting issue is not specifically addressed in subsequent reports or explanations.

A related issue is whether, in this same situation where the divorced spouse receives benefits and the participant continues working, the divorced spouse is entitled to share in any early retirement subsidy. The compromise reached on this second issue was that the divorced spouse would not be entitled to the subsidy unless the participant subsequently retires to qualify for the subsidy and the QDRO provides for increased payments to the divorced spouse in that event. *See* S. Rep. No. 575, 98th Cong., 2d Sess. 21 (Aug. 6, 1984). The apparent purpose of this compromise was to minimize "game playing" by participants at the expense of the divorced spouse. It was believed that a participant might otherwise delay retirement until the divorced spouse began to receive payments, so that the full value of any subsidy might be retained by the participant.

This opportunity for "game playing" does not exist in the vesting area, because the expected increase in the vesting percentage each year will be readily apparent and the divorced spouse can determine whether to wait for possible further vesting or receive immediate payments. In addition, the administrative burdens placed on plans if recalculation and increased benefits were required would frequently be substantial. Many plans provide for graduated vesting over a period of years, and recalculation could thus be required 5 or even 10 times in the case of some QDROs. One way to clarify this point would be to revise the parenthetical language contained in section 414(p)(4)(A)(ii) to read as follows (new matter italicized): (but taking into account only the present value of the benefits which were actually accrued *and nonforfeitable as of such date* and not taking into account the present value of any employer subsidy for early retirement)

4. The Federal income and gift tax consequences of spousal waivers of benefits should be clarified.

A spouse may consent to waive post-retirement survivor benefits, preretirement survivor benefits, and the right to receive 100 percent of the account balance in an exempt profit-sharing or stock bonus plan. An area of considerable confusion is in what situations, if any, are benefits nevertheless taxable to the spouse under assignment of income principles? One argument is that, because benefits payable under qualified plans are only taxed when actually paid to the recipient, spouses should not be taxed on death benefits that they consent to forego in favor of another beneficiary. In any event, if spouses are to be taxed on death benefits they consent to waive, this important consequence should be clearly understood by spouses.

A similar problem arises in the gift tax area. Because consent is irrevocable by the spouse, it could be argued that a gift takes place at the time the consent is given. In this regard, we note that section 152(e)(2)(A) of H.R. 1800 would repeal section 2517 of the Code, which currently eliminates up to half of the potential gift tax liability, at least in community property states. Also, it appears that spousal consent of payment to a designated beneficiary would not constitute a "qualified disclaimer" under Code section 2518 and thus the exception provided by that section would be unavailable.

Section 2(f)(1) of H.R. 2110 contains a special transition rule for certain spousal waivers made on or before the close of first plan year to which the Act applies. The proposed statutory language states that such waivers would not result in gift tax, and the May 14, 1985 explanation of the bill by the Joint Committee staff indicates that such waivers would not increase a spouse's income. These provisions imply that waivers outside of this very limited transition period generally will have income and gift tax consequences to consenting spouses. If intended, these important results

should be explicitly stated and clarified. For example, does the "gift" take place when the waiver is signed or when the benefit is paid?

5. The proposed amendments to the spousal consent rules should be clarified.

Section 2(b)(6) of H.R. 2110 would amend the spousal consent rules to provide that consent is only effective where (1) the spouse "designates a beneficiary" which may not be changed without spousal consent, or (2) the consent specifically permits designations of beneficiaries by the participant without any requirement of further consent by the spouse.

We have several comments on these provisions. First, the proposed language could be interpreted to require the election to designate a beneficiary in all cases if the spousal consent is to be effective. Assume, however, a defined benefit plan where the spouse's consent to an election out of the preretirement or post-retirement survivor coverage results in the participant's receipt of larger annuity benefits and no death benefits payable to any other person. In order to deal with this common situation, proposed section 417(a)(2)(A)(ii) could be revised to include the following italicized language at the beginning thereof: "*if the plan provides for designation of another beneficiary where such election is made,* such election designates a beneficiary which may not be changed without spousal consent. . . ."

Second, the "designates a beneficiary" concept raises a variety of questions in terms of exactly how specific the designation must be, the effects of subsequent events, etc. For example, we would appreciate clarification in the committee report of how the following situations would be resolved.

1. Spouse consents to payment to "my child" or "my children" at the time when the spouse and participant have one child. A second child is born. Does either of the above consents permit division of the benefits among the two children, or is a new consent required?

2. Spouse consents to payment of equal shares to two children. May the participant subsequently designate that 60 percent of the benefits will be paid to the first child and 40 percent to the second? What if the spouse had consented to payment to "my children" without further elaboration?

3. Spouse consents to payment to a trust. May the participant redirect payments to a second trust? What if the beneficial ownership of the two trusts is identical?

4. May the spousal consent limit the form of payment to the other beneficiary? For example, suppose the spouse specifies that the beneficiary will receive payments in the form of a life annuity. May the participant direct that benefits be paid to this same beneficiary in a lump sum?

5. Finally, we support the provision of the bill which would allow the spouse to provide a one-time consent to beneficiary designations which may be made or changed in the future. In this regard, we disagree with the Treasury Department position that such "blanket consent" would seriously erode the original policy of the rules. We would expect that there will be a number of cases where (because of precise personal financial circumstances) spouses are willing to forego any direct interest in the participant's benefits and will not want to be bothered with having to provide additional consents as the participant changes beneficiaries. We also believe that, with relatively few exceptions, most individuals will understand the distinction between consenting to a specific beneficiary and providing a blanket consent. Accordingly, we recommend that this type of flexibility for plan participants and their spouses be preserved.

6. The transition rule to avoid double death benefits should be revised or eliminated, to remove any implication that double benefits are required outside the scope of the rule.

Section 2(f)(1) of H.R. 2110 provides that, in the case of a plan participant who dies before the expanded survivor annuity rules apply to the plan in general, but whose surviving spouse is nevertheless entitled to benefits because of the special rule of section 303(c)(2) of the Retirement Equity Act, the amount of any death benefit payable to any beneficiary may be reduced by the amount required to be provided to the surviving spouse. We understand that this provision was intended to help plans by making it clear that the same benefits do not have to paid twice, i.e., to both the designated beneficiary and the surviving spouse.

Unfortunately, this provision leaves the strong negative implication that plans may be required to pay the same benefit twice where a participant dies after the survivor benefit rules are generally applicable to the plan. For example, take the case of a calendar year single employer plan, for which the expanded survivor benefit rules became effective January 1, 1985. Many such plans have not yet been amended to incorporate the new requirements, and thus the terms of the plan may currently provide for payment to a nonspouse beneficiary. Such plans are not required to be amended to reflect the new rules until the end of 1985 (retroactive, of

course, to the beginning of 1985). Section 2(f)(1) of H.R. 2110 leaves the strong implication that, where a participant in such a plan dies in 1985 before the plan is amended, double payment of the same benefit is required. While we assume that such a result was not intended, we are very concerned that courts might interpret the provision to require double payments.

We suggest that this transition rule should be broad and not be limited to participants who die before the survivor benefit rules apply to the plan. Another possible approach is to delete section 2(f)(1) and address this important issue in the committee report. Thus, for example, the legislative history could make it clear that the general intent of Congress was that survivor benefits which were mandated by section 401(a)(11) and section 417 (including the transition rules) are to be offset against benefits payable to other beneficiaries so that plans would only have to pay the same benefits once.

In addition, it should be made clear that, merely because the election period ends with the participant's death, a surviving spouse may still voluntarily disclaim any interest in the participant's benefits (*e.g.*, for estate tax purposes) after the participant's death as long as the applicable rules are followed (subject to such income, estate, and gift tax consequences as may attach to such disclaimer). In this regard, we see no reason why plans should be forced to pay benefits directly to surviving spouses who make proper disclaimers in favor of another person.

7. The tax consequences of QDRO payments to alternate payees other than former spouses should be clarified.

Section 2(c)(1) of H.R. 2110 would amend Code section 402(a)(9), which relates to the tax treatment of an alternate payee receiving benefits under a QDRO. We understand that the intent of the amendment is generally to tax the participant on a QDRO payment if not made to a spouse or former spouse. For example, we understand that QDRO payments to a child would be taxed to the parent participant.

Although the apparent intent of this change is to minimize tax planning opportunities to divorcing spouses (and to prevent indirect deductions of child support payments), it does raise a number of important questions. We request that the related tax consequences of this amendment be clarified. In particular:

1. If a QDRO payment is made to a child, should information reporting on Form 1099R (or Form W-2P) be made as if the payment were made to the parent participant? We assume that such reporting would be appropriate.

2. Do the pension withholding rules under Code section 3405 apply to QDRO payments to a child, and, if so, how? For example, who should receive notice or elect out? Because of the lack of symmetry between the recipient of benefits and the payor of tax, we suggest that such payments be totally exempt from withholding.

3. May the child roll over QDRO payments to an IRA pursuant to Code section 402(a)(6)(F)? If so, is the parent's tax liability reduced? We assume that the child would be taxed on subsequent IRA distributions.

4. Does Code section 402(e)(4)(M) continue to apply to permit possible lump sum treatment with respect to other benefits taxed to (and in this case actually paid to) the parent participant?

We would emphasize that these are real issues of immediate concern to participants and plans. For example, Chevron would like to amend its section 402(f) notices to benefit recipients to provide guidance with respect to issues 3 and 4 above. Clarification of these issues, either in the statute or in the committee report, would be extremely helpful.

We appreciate this opportunity to comment. We would be pleased to discuss any of the above matters further with you or your staff.

Very truly yours,

LOUIS T. MAZAWEY,
DOUGLAS W. ELL,
(On behalf of Chevron Corp.).

STATEMENT OF COMMITTEE OF ANNUITY INSURERS

The Committee of Annuity Insurers, a coalition of 25 of the leading annuity companies in the United States, appreciates this opportunity to offer comments on H.R. 1800, the Technical Corrections Act of 1985. Our Committee, a list of the member companies of which is attached, was formed in 1981 to monitor legislative and regulatory issues affecting the annuity industry and annuity policyholders. As such, we worked closely with the Select Revenue Measures Subcommittee and with the full Ways and Means Committee in the development of the life insurance tax provisions in the Deficit Reduction Act of 1984 (the "1984 Act").

Part B of Title I of the Technical Corrections Act of 1985 would amend the provisions of the 1984 Act relating to life insurance company and life insurance product taxation. The Committee of Annuity Insurers would like to focus its comments on the amendments in Part B which relate to the annuity product. In particular, we will specifically address the proposed amendments to sections 817(h) and 72 of the Code.

H.R. 1800 would resolve a number of the issues which have arisen under the 1984 Act in connection with the annuity product. While we applaud the authors of this legislation for their efforts in this regard, we would like to suggest other amendments which we feel merit the Committee's consideration. In addition, we would like to bring to the Committee's attention three provisions in the Technical Corrections Act which we believe are substantive changes and therefore should not be incorporated in a technical corrections bill. These provisions relate to the treatment of section 403(b) annuities, the applicability of section 72(s) to gratuitous transfers of annuity contracts, and the applicability of the penalty tax to distributions at the death of the annuitant.

SECTION 817(h) OF THE CODE

Section 817(h) of the Code, as amended by the 1984 Act, provides that a variable contract (other than a pension plan contract), which is based on a segregated asset account, shall not be treated as an annuity, endowment, or life insurance contract for any period for which the investments made by such account are not "adequately diversified." In general, section 817(h)(1) calls for the requisites of "adequate diversification" to be spelled out in regulations that the Internal Revenue Service (the "Service") is to issue. However, the effective date for new section 817(h)(1) under the 1984 Act is January 1, 1984—the general effective date for the life insurance company tax provisions in the 1984 Act.

The legislative history of section 817(h)(1) indicates that Congress intended that the regulations called for under this provision would have a prospective effective date. As noted in the Senate Report explaining the revenue provisions of the 1984 Act and again in the General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 (the "Blue Book"), the Congress "anticipated that any regulations prescribing diversification standards changing current practices will have a prospective effective date."

The Internal Revenue Service has not, as yet, promulgated regulations under section 817(h)(1). However, last year a temporary regulation was issued by the Service which provides as follows:

"(a) IN GENERAL.—Any temporary regulations issued under the authority of section 817(h), relating to the diversification requirements for variable annuity, endowment, and life insurance contracts, will be effective for taxable years beginning after December 31, 1983.

(b) EXCEPTION.—If an insurance company would be considered the owner of the assets of a segregated asset account under the principles of Rev. Rul. 81-225, 1981-2 C.B. 12, at all times after the later of December 31, 1983, or the date on which the segregated asset account was established, the temporary regulations described in paragraph (a) of this section will not apply to such account until 90 days after their publication in the Federal Register."

In light of the foregoing, two questions have arisen as to the effective date of any regulations issued pursuant to section 817(h)(1) of the Code. First, what effect, if any, should such regulations have on situations that have been grandfathered (pursuant to section 7805(b) of the Code) in Rev. Rule. 77-85, Rev. Rul. 80-274, and Rev. Rul. 81-225, and various private letter rulings thereunder, as well as on situations where the funds involved have been "closed" pursuant to Rev. Rul. 82-55? Second, how much time should insurance companies be given to diversify their separate account investment portfolios in accordance with the proposed regulations? Although section 121(1)(1) of the Technical Corrections Act makes a number of changes to section 817(h) of the Code, it does not address these effective date issues.

1. "Grandfathered" situations

The industry is concerned about the possible effect the forthcoming regulations may have on situations covered by published and private letter rulings of the Service under prior law. In Rev. Rul. 77-85 (relating to investment annuities), policyholders were held to be the owners of assets held in custodial accounts created thereunder, but "grandfathering" relief was provided such that those accounts were treated as segregated asset accounts of the issuing insurance company (under former section 801(g)(1) of the Code) in the case of contracts entered into and contributions received thereunder prior to March 10, 1977. Similarly, in Rev. Rul. 81-225,

the Service described the situations in which an insurance company would not be deemed to be the owner of the underlying assets of so-called mutual fund "wraparound" annuities, but again "grandfathering" relief was accorded in the case of premiums paid on or before December 31, 1980. Moreover, several private rulings were issued grandfathering earlier private rulings which had been issued prior to the publication of Rev. Rul. 80–274 (which reached a conclusion contrary to the prior private rulings). Furthermore, in reliance on the foregoing published rulings (as well as Rev. Rul. 82–55) a number of funds were closed to further purchase by the public and ceased receiving contributions with respect to nonqualified annuity contracts. Although these funds continue to exist today, no new money is being received either from existing nonqualified policyholders or new nonqualified policyholders.

It appears that Congress intended new section 817(h) to apply prospectively. Applying this principle to the section 7805(b) relief provisions in various published and private rulings that had been issued prior to the passage of section 817(h), as well as to funds "closed" in reliance on such published rulings, it would appear that Congress clearly intended that such situations were not to be affected by new section 817(h). In order to implement this intent, it is suggested that the following provision be added at the end of section 121(1)(1) of H.R. 1800:

"(6) Paragraph (1) of this subsection shall not apply to—

"(A) any variable contract that was the object of the relief provision of section 7805(b) found in Rev. Rul. 77–55, Rev. Rul. 80–274, or Rev. Rul. 81–225 or private letter rulings thereunder; or

"(B) any variable contract which is based on an account which has been closed to the public in accordance with Rev. Rul. 82–55, and none of the assets of which are attributable to premium payments made by annuity purchasers in connection with contracts other than pension plan contracts after December 31, 1980.".

2. Adequate time to diversify

Prior to the enactment of section 817(h) of the Code, there were no statutory or regulatory standards for diversification of segregated asset accounts underlying variable contracts. While representations as to diversification had been required by the Service in connection with the submission of private letter ruling requests, these representations underwent substantial and continuous change over a period of several years. As a result, the Service issued favorable rulings to various companies with inconsistent diversification representations.

In light of these factors, promulgation of regulations on other than a prospective basis would be unfair and would create unnecessary administrative and market disruption. Furthermore, the change period should be of sufficient length to permit companies to alter their investments to meet the applicable diversification requirements. At minimum, companies should be given one year from publication of the final regulations to diversify their portfolios. Allowance of a one year period would be consistent with the Service's current practice, in the case of private rulings, of allowing newly formed insurance companies or separate accounts 365 days within which to diversify their investment portfolios adequately.

In addition to the effective date problem, the Committee of Annuity Insurers wishes to call to the Committee's attention a question which has arisen in regard to section 817(h)(3) of the Code. Section 817(h)(3), as added by the 1984 Act, provides that, irrespective of the diversification regulations to be promulgated by the Service pursuant to paragraph (1) of section 817(h), a variable life insurance contract may be based on a segregated asset account which is fully invested in securities issued by the United States Treasury. A question arose after enactment of the 1984 Act as to whether this exception for variable life insurance contracts would be available if the account was not "fully" invested in Treasury securities. For example, would the section 817(h)(3) exception be available if the separate account invested 99% in Treasury securities.

Section 121(1)(1) of the Technical Corrections Act would resolve this "fully" invested issue. However, read literally, the language in section 121(1)(1) would seem to permit a separate account which invests any amount in Treasury securities to be deemed adequately diversified, irrespective of other investments of the account. For example, under the proposed language, the entire separate account might be considered adequately diversified even if it invests only 1% assets in Treasury securities. Obviously, this was not intended. Section 817 clearly requires that the entire account be adequately diversified, and not just a portion of it. Thus, the other investments of the account should still be required to meet the diversification standards

prescribed by regulations or the safe harbor in order for those assets, and in turn the entire account, to be treated as adequately diversified.

SECTION 72(s) OF THE CODE

Section 72(s) of the Code, as added by the 1984 Act, provides that an annuity contract must contain certain rules for distribution of the contract's values in the event of the contractholder's death. Section 126(a) and (b) of the Technical Corrections Act of 1985 would amend section 72(s) of the Code so as to clarify a number of ambiguities which have arisen in connection with these so-called "distribution-at-death" rules. These amendments go a long way towards resolving some of the uncertainties in the 1984 Act. However, a number of questions still remain which we would like to bring to the Committee's attention.

1. Treatment of section 403(b) annuities

As noted above, under section 72(s) of the Code, an annuity contract will not be treated as such for tax purposes unless the contract contains provisions requiring certain distributions in the event of the holder's death. Section 401(a)(9) of the Code contains similar distribution-at-death rules governing trusteed and non-trusteed qualified plans. In addition, section 401(a)(9) imposes before-death distribution rules on such contracts. Under these rules, a distribution is required generally beginning April 1 of the calendar year following the year in which (1) the employee attains age 70½ or (2) the employee retires, whichever is later. Section 72(s) does not contain any such before-death distribution rules.

After the 1984 Act, a question arose as to which distribution-at-death rule applied in the case of a section 403(b) annuity—section 72(s), section 401(a)(9), or both? The Technical Corrections Act would resolve this issue by providing in sections 126(a) and 152(a)(3) of such Act that section 403(b) annuities are not subject to section 72(s), but are covered by section 401(a)(9) of the Code. By subjecting section 403(b) annuities to the requirements of section 401(a)(9), the bill would impose before-death distribution requirements on such contracts. Addition of such a requirement is a major change in the law and should not be part of a technical corrections bill.

Furthermore, if enacted, this proposal would impose a substantial administrative burden on insurers. As proposed, section 152(a)(3) would be applicable to contributions made after the date of enactment of the Technical Corrections Act. Thus, for existing contracts, an insurer would be required to separate each person's cash value into portions representing contributions received before the effective date of the Technical Corrections Act and contributions received after the effective date of the Act. At a minimum, a change of this nature should not apply to existing contracts. Companies should be given sufficient time to amend their contracts and refile such contracts with the applicable authorities. For example, when Congress added the section 72(s) distribution requirements in 1984, it made them applicable only to contracts issued six months after date of enactment of the 1984 Act.

There is no evidence in the legislative history of the 1984 Act to indicate that section 401(a)(9) would be applicable to section 403(b) annuities. In fact, other provisions of the 1984 Act indicated that such contracts should be governed by section 72(s). Hence, many companies assumed that section 403(b) annuities would be subject to the rules of section 72(s), and amended their contracts to comply with those rules. Therefore, we urge the Committee to amend sections 126(a) and 152(a)(3) of the Technical Corrections Act to provide that section 72(s) of the Code, and not section 401(a)(9), will apply to section 403(b) annuities.

2. Special rule for individuals holding in representative capacity

Section 126(b)(1) of the Technical Corrections Act would amend section 72(s) of the Code so as to clarify the application of the distribution-at-death rules where the contractholder is not an individual. Under the proposed amendment, a "look-through" rule would be applied so that the primary annuitant would be treated as the holder of the contract, for purposes of section 72(s), if the contractholder is not an individual. While this amendment would resolve the issue of how section 72(s) is to apply where the holder of the contract is a corporation, it does not address the treatment of holders who are individuals but are acting only in a representative capacity, such as custodians or trustees. In order to resolve this problem, it is suggested that the language in proposed new Code section 72(s)(6)(A) be amended so as to extend the non-individual holder rule to include such individuals. As amended, the paragraph would thus provide that, if the contractholder is not an individual or is an individual acting in a representative capacity, the primary annuitant will be treated as the holder of the contract for purposes of section 72(s).

3. Gratuitous transfers of annuity contracts

Section 126(b)(1) of the Technical Corrections Act would amend section 72(s) of the Code by adding a new paragraph relating to the treatment of certain transfers of ownership of an annuity contract. Under the provision, if an individual who holds an annuity contract transfers such contract by gift, such transfer will be treated as the "death of the holder," thus forcing the entire interest in the contract to be distributed to the designated beneficiary under the contract. The identical rule would apply to a change in the primary annuitant in the case of a contract where there is a non-individual holder.

This proposed amendment is a substantive change in existing law and as such should not be included in a technical corrections bill. Furthermore, equating gratuitous transfers of annuity contracts with the death of the holder of the contract raises a number of technical questions which should be thoroughly explored before any action is taken. A simple example illustrates how this proposed amendment may go well beyond its intended result. Assume that individual holder X transfers, by gift, his deferred annuity contract to Corporation Y. Under the terms of the contract, X is the annuitant and upon X's death, his son S is to be the beneficiary of the contract. Thus, after the transfer, Corporation Y will be the holder of the contract, X will be the "primary annuitant," and S will be the beneficiary. If the proposed amendment is adopted, the transfer of the contract to Y will trigger a distribution of the contract's values to S. This will occur even though (assuming the other amendments in section 126(b) of the Technical Corrections Act are adopted) X is, for section 72(s) purposes, the "holder" of the contract both before and after the gratuitous transfer.

In its pamphlet describing the provisions of the Technical Corrections Act of 1985, the staff of the Joint Committee on Taxation indicated that the gratuitous transfer/distribution-at-death amendment was needed to ensure that individuals do not "avoid" the section 72(s) rules and continue deferral beyond the life of an individual taxpayer. If a problem of this nature does exist, we believe that there are more appropriate means of addressing the issue. For example, consideration should be given to amending section 72(e)(4)(A) of the Code (relating to loans or assignments of annuity contracts) to cover such gratuitious transfers.

At this time, we urge the Ways and Means Committee to delete the gratuitous transfer provision in section 126(b)(1) of the Technical Corrections Act of 1985. If the Committee nonetheless decides to restrict gratuitous transfers or changes in primary annuitants, it is critical that an exception for changes or transfers to surviving spouses (similar to that in section 72(s)(3) of the Code) be provided.

SECTION 72(q) OF THE CODE

Under section 72(q) of the Code, as added by the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), a five percent penalty tax is imposed on certain premature distributions from an annuity contract. However, the Code goes on to provide, in paragraph (2) of section 72(q), that certain specified distributions from an annuity contract will not be subject to the penalty tax. A number of questions have arisen as to the applicability of these exceptions to corporate taxpayers and as to the interaction of these exceptions with the new distribution-at-death rules in section 72(s).

1. Death of the annuitant

Section 126(c) of the Technical Corrections Act would resolve a problem which developed as a result of the potential interaction of the distribution-at-death rules in section 72(s) of the Code and the five percent penalty tax in section 72(q) of the Code in the situation where the holder and the annuitant are not the same person. Under current law, because there is no exception in section 72(q)(2)(b) of the Code for distributions made upon the death of the holder, a beneficiary may be forced to pay a penalty tax on a distribution that was made solely because of the requirements of section 72(s) of the Code. The Technical Corrections Act would amend section 72(q)(2)(B) so as to provide that the penalty tax would not apply to any distribution made on or after the death of the holder or, where the holder is not an individual, the death of the primary annuitant.

However, in solving the distribution-at-death/penalty tax exception problem, the bill would create another problem in that the proposed amendment would delete the exception in current law for distributions made on or after the death of the *annuitant.* Thus, as of January 19, 1985, if a distribution were made under an annuity contract (in which the holder and the annuitant are two separate individuals) because of the death of the annuitant, the beneficiary may be forced to pay the penal-

ty tax. Imposition of the penalty tax on a distribution made because the measuring life (i.e., the annuitant) under the contract has died is unwarranted and is contrary to the original purpose of the penalty tax. The penalty tax was enacted in 1982 in order to prevent "premature" distributions from annuity contracts and thus to ensure that such contracts are not used as short-term investment vehicles. Clearly, providing an exception for distributions made because the measuring life under the contract has died in no way defeats this objective.

In order to avoid this result, the Committee of Annuity Insurers requests that section 126(c) of the Technical Corrections Act be amended so as to ensure that the penalty tax will not apply in the case of distributions made pursuant to section 72(s) [the distribution-at-death rules] or made upon the death of the annuitant.

2. Application of penalty tax exceptions to corporate taxpayers

As noted earlier, section 126(b)(1) of the Technical Corrections Act would amend section 72(s) of the Code so as to provide that the primary annuitant will be treated as the holder of the contract if the contractholder is not an individual. Under section 126(c) of the Technical Corrections Act, this same "look-through" rule would also apply for purposes of section 72(q)(2)(B) of the Code. Section 72(q)(2)(B), as amended by this bill, would exempt from the penalty tax distributions made upon the death of the contractholder or in the case of a non-individual holder, distributions made upon the death of the primary annuitant. However, the bill fails to address the issue of whether this same "look-through" rule should apply to the other exceptions from the penalty tax in section 72(q)(2). For example, in section 72(q)(2)(A), a distribution made on or after the taxpayer attains age 59 ½ will not be subject to a penalty tax. If the "taxpayer" is a corporation, it is unclear how this exception can be applied. A similar issue arises under the exception for distributions made due to the disability of the taxpayer (section 72(q)(2)(B)) and the exception for distributions of substantially equal periodic payments over the life of the taxpayer (section 72(q)(2)(D)).

In order to resolve the questions which have arisen since enactment of TEFRA as to the applicability of these provisions in the case of the corporate taxpayer, the Committee of Annuity Insurers recommends that the Ways and Means Committee amend H.R. 1800 so as to apply the "look-through" rule to all of the penalty tax exceptions in section 72(q)(2) of the Code. The proposal to extend the "look-through" rule to individuals acting in a representative capacity should also be incorporated in the amendments to section 72(q).

CONCLUSION

The Committee of Annuity Insurers again wishes to thank the Ways and Means Committee for this opportunity to comment on H.R. 1800, the Technical Corrections Act of 1985. We commend the Committee and its staff for their efforts to resolve a number of the technical issues which have arisen since enactment of the 1984 Act and respectfuly request that the additional amendments which we have proposed be incorporated in any technical corrections legislation reported by the Ways and Means Committee.

STATEMENT OF DR. RONALD MUELLER, DEVELOPING SYSTEMS, LTD.

In hearings prior to passage of the Deficit Reduction Act of 1984, testimony was given that justified restriction of the use of tax-exempt funds for student and private consumer lending. The result was Section 626 of the Act, amending Subsection (o) of Section 103 of the Internal Revenue code. This section denies federal tax-exempt status to "consumer loan bonds" issued by states and local jurisdictions. The laudable purpose of this clause was to foreclose tax-exempt status to the financing of individual consumer credit loans. The language of the Act and its legislative history are clear.

However, the Technical Corrections Act seeks to extend this prohibition by changing "consumer loan bond" to the much broader term "private loan bond." This is not simply a change in wording but has much broader implications. The new wording would restrict possible lending to private business. This would seriously change the meaning of the law and the legislative intent. Any such fundamental change of law, in our view, deserves very close attention and should receive it in the context of the omnibus tax simplification and reform legislation now in the works.

STATEMENT OF STEPHEN GURKO, VICE PRESIDENT, DUCKER, GURKO & ROBLE, P.C., DENVER, CO

TOPICAL SUMMARY

The Tax Reform Act of 1984 (the "Act") provides for multiple trusts to be treated as one trust for tax purposes under certain circumstances. Section 106(a) of H.R. 1800 (the "Bill") provides that this provision of the Act does not apply to a trust which was irrevocable on March 1, 1984, except to the extent corpus is transferred to the trust after that date. This Statement proposes that the date of March 1, 1984, be changed to July 18, 1984, which was the date of enactment of the Act.

STATEMENT

The Act's and the Bill's provisions are sound public policy with respect to multiple trusts. It must be recognized, however, that the Act's provisions go well beyond the existing Treasury Regulations in regard to the circumstances in which multiple trusts may be treated as one trust for tax purposes. For example, the Act permits such treatment where tax avoidance is a principal purpose for the multiple trusts (not just where the multiple trusts lack a substantial non-tax purpose, which is the rule under the Regulations), and where the multiple trusts have substantially the same "primary" beneficiary (not just where they have substantially the same beneficiary, which is the rule under the Regulations). Therefore, application of the Act's provisions on a prospective basis only, as provided for in the Bill, is appropriate.

The Bill's proposed effective date of March 1, 1984, is too early a date to treat taxpayers as reasonably on notice of the Act's change in existing law. Although sometimes it is appropriate to specify the earliest Congressional committee announcement date as the effective date for a new tax provision, this approach is not appropriate in the present situation. The various individual grantors and trustees of trusts around the country cannot be expected to keep informed of potential legislative developments on a daily basis. Many new trusts were undoubtedly created, and new gifts made to existing trusts, after March 1, 1984, in reliance on existing law.

It is recommended that an effective date of July 18, 1984, be substituted for the proposed effective date of March 1, 1984, in Section 106(a) of the Bill. July 18, 1984, is the date of the Act's enactment, after which all taxpayers should be presumed to know about the Act's provisions. Alternately, an effective date before July 18, 1984, but after March 1, 1984, is recommended. A third alternative would be to retain the March 1, 1984, effective date as the general rule, but allow a later effective date (preferably July 18, 1984) for new trusts (or gifts to existing trusts) in circumstances where the Act but not the existing Regulations would require treatment of the trusts as a single trust.

Respectfully submitted on this 25th day of May, 1985.

ESSEX COUNTY, NJ, *May 15, 1985.*

Hon. DAN ROSTENKOWSKI,
Chairman, House Ways and Means Committee, Washington, DC.

DEAR MR. CHAIRMAN: Pursuant to consultations with Congressman Frank Guarini, I am writing in regard to the proposed sale-leaseback of the Essex County Courthouse in the heart of Newark's downtown area which would result in a $14 million restoration of this historic structure. This is an issue of exceedingly great importance to Newark and to Essex County and is a project that has been under development for a considerable period of time, well in advance of last year's federal tax legislation, a fact which I can document.

The Essex County Courthouse is one of the finest examples of Beaux Arts construction in the State of New Jersey and, indeed, in the United States. It was designed by the world famous architect, Cass Gilbert, who designed the Supreme Court Building in Washington, D.C. The artwork was executed by such internationally famous artists as Edwin Blashfield, Howard Pyle, Kenyon Cox and Francis D. Millet whose works are also an integral part of the Library of Congress and the Supreme Court Building. We are proud that the Essex County Courthouse is on the National Register of Historic Sites and Places.

The Courthouse is in a serious, advanced state of deterioration and if the building does not receive immediate attention, it will soon be impossible to successfully restore it and salvage the valuable artworks it houses.

We wish to assure you that we have explored all the impossible federal, state, local and private sources of support. As you know, in the past there were other

direct funding programs available for historic restoration, but even so, the funds were inadequate. For example, Essex County in June of 1983 applied for $100,000 from the United States Department of the Interior to help restore the Courthouse. The entire State of New Jersey received only $450,000 for historic restoration, of which we did receive $50,000. There are presently no federal or state programs in place which would provide the necessary funds for the emergent work required. I would note here that this application for and receipt of federal funds for this Courthouse project occurred in June of 1983, and is just one of the significant governmental actions to which we can point to document our case.

We also explored federal EDA funding. In June of 1983 we also developed a comprehensive application to the U.S. Department of Commerce (EDA) for the restoration of this project. This $1,000,000 comprehensive application contained complete architectural renderings and engineering plans—again, further testimony to the existence of this project prior to the tax legislation and further evidence of clear significant governmental actions taken by us.

We, furthermore, can point to the actions taken by the County to engage in feasibility studies, engage engineering, governmental relations and other services in 1982 and early 1983 on this project. The Board of Freeholders of Essex County had taken formal actions to adopt an ordinance to issue bonds for partial restoration efforts during the same period.

At the time the House Ways and Means Select Subcommittee on Revenue first reported out its sale-leaseback legislation we asked Chairman Peter Rodino and Congressman Frank Guarini to discuss this project with you, which they did. Essex County was advised by Ways and Means staff that because our project did not involve the use of Accelerated Depreciation (ACRS) as part of the financing package, we would be "outside the scope" of what was termed the "Pickle Bill" at that time. For this reason, we did not even seek any grandfathering of this particular project in your bill.

By the time the Senate Finance Committee acted on this matter, and it became clear that the ITC component of our project would be jeopardized, we did seek such recognition. As you can see from the attached floor statement of Chairman Dole, the Courthouse was one such project that was clearly under discussion for such recognition.

It was believed that the generic rules Chairman Dole sought would satisfactorily cover our project. However, some questions by our investors have been raised, and without Congressional clarification that those significant governmental actions we undertook meet the tests in your view, they will not go forward.

This brings us to the Committee now. I can firmly testify that this was a project long under development well before the tax legislation of last session. It was not just a gleam-in-the-eye project at the time Congress acted on sale-leaseback arrangements. I can firmly testify to the fact that I have fully explored all other sources of support, and those efforts serve to document our "significant governmental actions" and documents the extent to which the project was underway.

We have explored possible language with your staff. I have attached the language worked out with Committee staff. I have also attached memoranda from our legal counsel and other documentary evidence that significant governmental actions had been taken on this project in 1982 and early 1983.

Essex County is the poorest and third highest-taxed county in the State of New Jersey. One-fourth of the entire state's welfare and food stamp population is located in Essex County. This past year we had a substantial budget deficit and there is the prospect of an even higher deficit in 1985. Our current budget situation is serious enough to warrant the layoff of 200 county employees. Our deteriorating infrastructure, together with our noncompetitive tax structure has resulted in partial exodus of the business community from many of our urban areas resulting in a dimunition of our limited tax base. Our already over-burdened taxpayers cannot absorb the additional $14 million repair bill.

A sale-leaseback, in short, is the only mechanism available to us for restoring the Essex County Courthouse . . . a structure that is truly one of our nation's architectural gems.

I would deeply appreciate your assistance in making this project a reality.

Sincerely,

PETER SHAPIRO,
County Executive.

Attachment.

If—

(i) on June 16, 1982, the legislative body of the local governmental unit adopted a bond ordinance to provide funds to renovate elevators in a deteriorating

building owned by the local governmental unit, which is listed on the National Register of Historic Sites and Place;

(ii) the chief executive officer of the local governmental unit, in connection with the renovation of such building, made an application on June 1, 1983 to a state agency for a federal historic preservation grant and made an application on June 17, 1983 to the United States Economic Development Administration of the Department of Commerce for a grant;

then the provisions of section 31 (g) (4) of this act have been satisfied.

STATEMENT OF HARRY D. GARBER, VICE CHAIRMAN, THE EQUITABLE LIFE ASSURANCE SOCIETY OF THE UNITED STATES

Mr. Chairman and members of the committee, I am a Vice Chairman of the Equitable Life Assurance Society of the United States, a mutual life insurance company and the third largest life insurance company in the United States. I am submitting this testimony to discuss the impact of the provisions of the Internal Revenue Code of 1954 relating to so-called golden parachute arrangements. These provisions were enacted into law by The Deficit Reduction Act of 1984 (DEFRA).

I am pleased to have this opportunity to comment on the golden parachute provisions and to urge that H.R. 1800, The Technical Corrections Act of 1985, incorporate provisions to address certain problems associated with those provisions.

EQUITABLE'S RECENT EXPERIENCE

Equitable recently acquired all the outstanding stock of a major financial concern which provides investment banking, securities and commodities brokerage and other related financial services. Its operations are international in scope, and it has approximately 3,800 employees and 50 domestic and foreign offices. The acquisition was a "friendly" transaction involving a tender offer to shareholders and not a "hostile" transaction in which the target corporation resisted being acquired. Before the transaction the acquired company had not established generous severance packages designed (1) to forestall potential "unfriendly" acquisition attempts and (2) to compensate executives who might be terminated as a result of the change in control.

The business of the acquired corporation involves the provision of personal services to customers and has few fixed assets. The profitability of the corporation is dependent primarily upon the performance of individual employees and the relationships between employees and customers of the corporation. Accordingly, in order to preserve and enhance the value of this acquired personal service business, the acquisition transaction involved the execution of covenants not to compete and employment contracts with key executive, management and professional personnel. The compensation arrangements were entirely within industry norms for the responsibilities involved. These arrangements served to ensure that Equitable, as the acquiring corporation, received a valuable on-going enterprise in exchange for the consideration paid to the public for the stock of the acquired corporation.

Because of the structure of the provision's "safe harbor test", which my later testimony will show was designed for persons who do not continue in the employment of the acquired corporation, Equitable and many of the employees covered under these arrangements might have to satisfy an extraordinary burden of proof in order to avoid the onerous and unexpected tax penalties involved. I am concerned that, contrary to its original intent, the golden parachute provisions will be applied primarily to employees who were not in a position to influence the target corporation's response to a proposed takeover and who stay with an acquired company and perform substantial services on a full time basis after the change in control. And if this is the main group affected, it would, in an unintended fashion, serve to limit acquisitions, particularly acquisitions of personal services firms whose main assets are their people. I believe this to be contrary to the original intent of Congress.

My comments with respect to the golden parachute provisions will first address their broad scope, emphasizing their potential application to many non-abusive employment arrangements. Next, I will focus upon the problems associated with the extraordinary burden of proof which taxpayers must satisfy in order to avoid unexpected tax consequences. Finally, I will describe certain technical problems, including the manner in which base period compensation is determined.

SCOPE OF PROVISION IS BROADER THAN NECESSARY TO ACCOMPLISH LEGISLATIVE PURPOSE

The genesis of this legislation was a concern by Congress that golden parachute arrangements hinder acquisition activity in the marketplace and "assist an entrenched management team to remain in control." Congress viewed a typical golden parachute as an arrangement whereby the target corporation agrees to make special payments to a key executive in the event that the corporation is successfully taken over and the executive's position is eliminated. Congress focused on the use of generous multi-million dollar severance packages for key executives of publicly held companies as a defensive tactic in anticipation of a possible "hostile" takeover.

Congress believed that golden parachute arrangements should be strongly discouraged because, by increasing the cost of the acquisition, they could have the effect of dissuading an interested purchaser from proceeding with the acquisition. To the extent potential "hostile" acquisitions are discouraged, the target's executives have helped to preserve their management positions. In the event an acquisition occurs despite the existence of golden parachute arrangements, Congress believed that it is inappropriate to use corporate funds and the tax law to subsidize highly compensated executives who leave the company.

While the statutory provisions are intended to apply to a management which controls a large, public corporation facing a hostile takeover and which places its interests above that of the public shareholders, the provisions will cover more often situations in which the perceived abuses are not present. Parachute payments are defined so broadly that potentially they reach almost all severance and other compensation arrangements where there has been a change of control, irrespective of (1) whether the payments are made to individuals who possess the power to direct the policies of the target corporation or (2) whether the employee leaves or stays with the corporation after it is acquired. To the extent compensation payments are considered "excess parachute payments," the employer and employee suffer substantial tax costs which are intended to be penal in effect. Specifically, such payments are not deductible by the employer and recipients are subject to a nondeductible 20% excise tax in addition to their regular income tax liability. Further, employers are required to deduct and withhold the excise tax from any such payments made to an employee.

Most of the persons impacted by the provisions would be persons who had no influence on the acquisition decision (non-control persons), who remain actively at work following a change of control, and some portion of whose compensation arrangement was negotiated on an arm's length basis incident to the change in control. For example, if a collective bargaining agreement or long-term employment contract is modified or entered into incident to a change of control, payments pursuant to such agreements might be treated as parachute payments if made to employees who are either officers, shareholders or "highly compensated individuals." Existing law does not provide clear guidance as to when an individual is "highly compensated." Other tax provisions suggest that "highly compensated" could be interpreted to apply to the top ⅓ of all employees. In certain financial institutions, "officers" may include a large percentage of employees. The provisions would also apply to low paid employees who own small amounts of stock. Thus, the provisions are applicable to large numbers of employees who have no influence over a corporate change in control. I would like to emphasize that one effect of subjecting non-control persons to the golden parachute provisions is that many key employees will seek employment with competitors who can offer similar compensation packages without the risk of penalty taxation.

The potential application of the golden parachute rules to non-abusive employment arrangements is illustrated by the examples contained in Exhibit I attached hereto. The examples involve situations in which a 5-year employment contract is entered into incident to a friendly acquisition to retain the future services of an employee. Pursuant to the employment contract, the employee is granted various commonplace compensation packages. The examples show that the "3 times the base amount" safe harbor is not sufficient to remove from the scope of the statutory provisions large numbers of employees who are not in a position to influence the decisions of the target corporation with respect to any proposed acquisition. Indeed, the first example shows that an employee who signs a 5-year employment contract which only guarantees the continuation of existing base period compensation (without any fringe benefits or bonuses) for the length of the employment contract would be subject to the golden parachute penalties, unless the stiff burden of proof as to reasonable compensation is satisfied.

Under the "3 times the base amount" safe harbor, payments which are defined to be contingent on a change in control will not be considered parachute payments if

the total present value of all such payments are less than 3 times the employee's average annualized compensation from the acquired corporation over the five-year period prior to the change in control. This form of safe harbor construction was obviously designed to deal with persons whose employment is terminated as part of the acquisition transaction. As demonstrated by the examples contained in Exhibit I, the safe harbor does not, as a practical matter, help employees who stay with the acquired company.

Further, even though Congress focused on the use of golden parachutes in the context of acquisitions of publicly-traded corporations, emphasizing the need to protect public shareholders, the provisions apply to privately-held corporations as well. There appears to be little justification for applying the provisions to compensation arrangements between executives and a privately-held corporation which undergoes a change in control, as the shareholders in such cases typically have more knowledge and control of the corporation and the activities of management.

REASONABLE COMPENSATION EXCEPTION

Characterization as an "excess parachute payment" can be avoided if the taxpayer establishes by clear and convincing evidence that the payments represent reasonable compensation for personal services actually rendered. This creates significant uncertainty for taxpayers who must satisfy this extraordinary and stiff burden of proof to avoid unexpected tax penalties. There is no clear guidance in the law as to either what constitutes reasonable compensation or what evidence would be "clear and convincing".

As the question of whether a payment is reasonable compensation will depend importantly on each person's particular facts and circumstances, the statute will necessarily involve a considerable amount of litigation. Moreover, with the extraordinary burden of proof placed on the taxpayer, many non-abusive compensation arrangements which the taxpayer could have shown to be reasonable under the usual tax law burden of proof will be challenged by the IRS. It is particularly disturbing that, because of the extraordinary burden of proof required, many taxpayers will not prevail in court even though the facts do not involve the abusive situations contemplated by Congress.

In view of the broad scope of the golden parachute provisions, taxpayers will be faced with the prospect of having to defend compensation arrangements for large numbers of employees under an onerous burden of proof which ensures that the IRS will prevail in most cases, regardless of whether a golden parachute in fact existed or whether the employee was in a position to influence the decisions of the target corporation.

BASE PERIOD COMPENSATION

The tax penalty does not apply to a parachute payment to the extent of an individual's "annualized includible compensation for the base period." Although parachute payments include all compensation which is defined to be contingent on a change in control, the definition of "annualized includible compensation," however, takes into account only income includible in an employee's gross taxable income, and excludes a significant portion of an employee's total compensation package. This has the effect in many cases, of substantially understating an employee's historic compensation. As a consequence, too large a percentage of compensation may be treated as a parachute payment.

Non-taxable fringe benefits such as employer contributions to employee benefit plans often represent a major component of total compensation and should be counted in determining base period income. Similarly, all compensation earned under arrangements established in the normal course of business prior to a change in control should be taken into account for purposes of determining base period compensation, irrespective of whether the compensation was taxable to the employee or whether the compensation was vested or payable as of the change in control. Examples of specific items which appear to be excluded from base period compensation include the value of unexercised stock options, the value of stock appreciation rights, deferred compensation or long term incentive plans, benefits and contributions under qualified and non-qualified pension or profit sharing plans, and employer contributions under other employee benefit plans which are excludible from an employee's income.

MISCELLANEOUS TECHNICAL COMMENTS

The penalty taxation of payments under an agreement that might violate federal or state securities laws or regulations represent another potential problem. The exception for reasonable compensation and the "3 times the base amount" safe-harbor are inapplicable. The type of violations that trigger such severe consequences are not defined in the statute and may be unrelated to the perceived abuses which Congress sought to address in this legislation. Inclusion of state securities laws and regulations as a trigger adds further uncertainty since the applicability of state securities law to change of control situations is often unclear. Further, the statute burdens the Treasury Department with responsibility of determining whether a violation of federal and state securities laws has occurred.

The statute has a number of other uncertainties. If an employee transfers employment to the acquiring corporation or target immediately prior to receiving payments, the employee may be treated as having a zero base period compensation. The date for determining the present value of payments is not stated.

In addition, it is often not feasible to reasonably determine the amount of parachute payments to use in the calculation if the rights to payment or the amount payable is contingent on future events. The problem is particularly acute if an employee receives property that may appreciate.

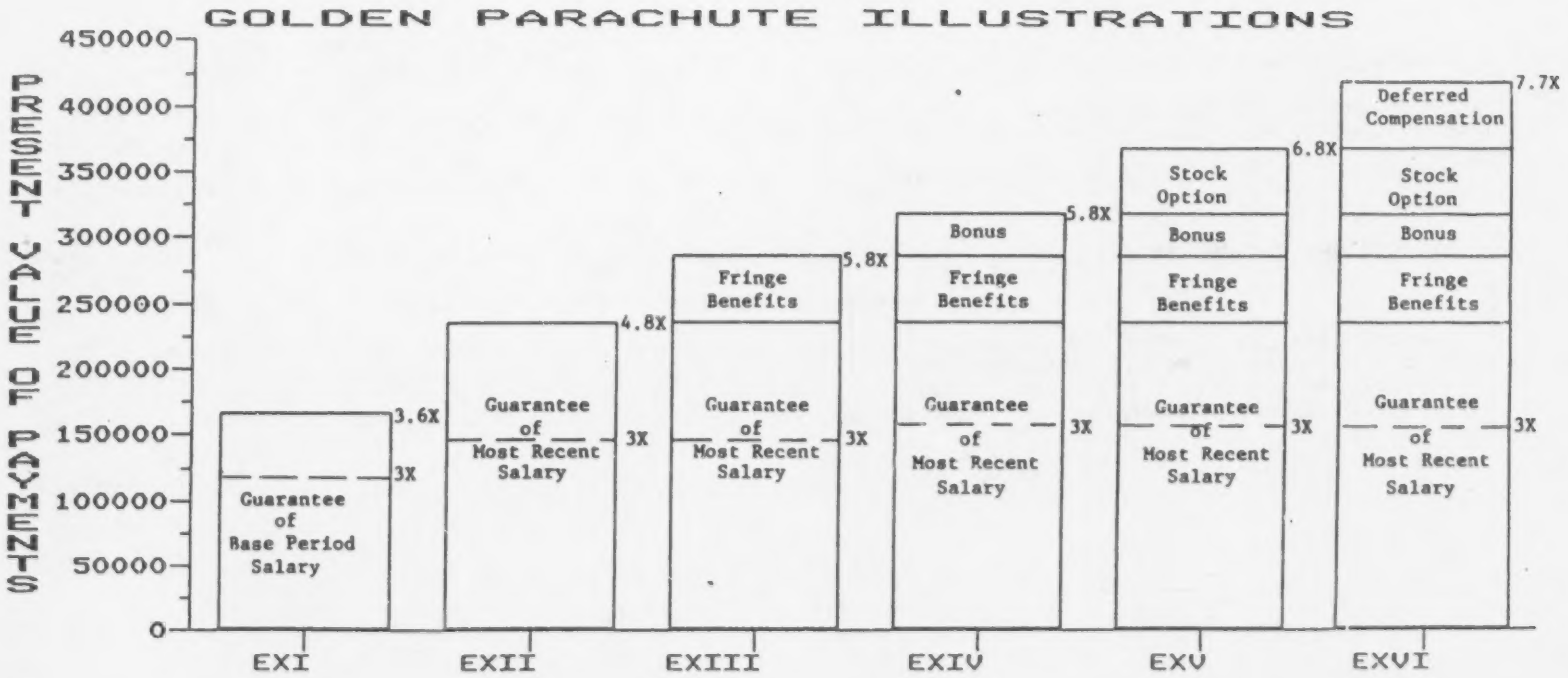
In summary, I believe the golden parachute provisions create substantial uncertainty with respect to legitimate transactions entered into for valid business reasons. In particular, the extraordinary burden of proof coupled with the broad scope of the statutory provisions, would impose significant tax penalties upon many nonabusive compensation arrangements with employees who remain actively employed on a full-time basis with the acquired corporation.

I would be pleased to work with your staffs in an effort to correct the imperfections of the golden parachute provisions. I have a number of ideas on how the provisions might be modified to eliminate or reduce the impact of the problems identified in this testimony.

My testimony is not intended to be an exhaustive commentary on the golden parachute provisions; there are some other important technical matters which also need to be addressed in the technical amendments legislation.

Thank you for permitting me to submit this testimony.

EXHIBIT I


GOLDEN PARACHUTE ILLUSTRATIONS
PRESENT VALUE TO PAYEES
450000
400000
350000
300000
250000
200000
150000
100000
50000
0
Guarantee of Base Period Salary
3X
3.6X
Guarantee of Most Recent Salary
3X
4.8X
Fringe Benefits
Guarantee of Most Recent Salary
3X
5.8X
Bonus
Fringe Benefits
Guarantee of Most Recent Salary
3X
5.8X
Stock Option
Bonus
Fringe Benefits
Guarantee of Most Recent Salary
3X
6.8X
Deferred Compensation
Stock Option
Bonus
Fringe Benefits
Guarantee of Most Recent Salary
3X
7.7X
EXI
EXII
EXIII
EXIV
EXV
EXVI

EXAMPLES OF THE OPERATION
OF GOLDEN PARACHUTE PROVISIONS

ASSUMPTIONS

- The examples describe various compensation arrangements of an Account Manager of XYZ Corporation. Relative to the other employees of XYZ Corporation, the Account Manager is a highly-compensated individual and, therefore, subject to the golden parachute provisions. The Account Manager is not an officer or shareholder, and does not possess the power to direct the policies of XYZ Corporation.
- A change of control of XYZ Corporation occurs on December 31, 1984.
- Prior to the change in control, the Account Manager was employed "at will" without an employment contract.
- Total annual compensation is paid to the Account Manager on July 1 of each year.
- The present value of parachute payments is determined using an assumed interest rate of 14 percent [120% of 11.63% (the mid-term applicable federal rate in effect at the time of the change in control)].
- "Base period" means the period up to five taxable years of the Account Manager preceding the taxable year in which change in control occurs.

GOLDEN PARACHUTE LEGISLATION

EXAMPLE I - Level Salary During Base Period and Guarantee of Level Salary during Contract Period

Facts:

- The Account Manager was hired during 1983 at a salary of $40,000. The Account Manager is not eligible to receive a bonus or other compensation, and does not receive any fringe benefits.
- At the time the change of control occurs, the Account Manager enters into a five year employment contract with XYZ Corporation that guarantees the continuation of the existing compensation arrangement (i.e., $40,000 annual salary, no benefits, no bonus) for the term of the agreement.

Total Parachute Payments	Average Includible Compensation	Safe Harbor Amount	Present Value of Parachute Payments	Excess Parachute Payments	Safe Harbor Needed	% of Total Compensation in Safe Harbor Computation
$200,000	$40,000	$120,000	$146,640	$160,000	3.6X	100%

All payments under the contract	Annualized 1983 salary	3 times $40,000 average compensation	1985 $ 37,480 1986 32,880 1987 28,840 1988 25,280 1989 22,160 $146,640	$200,000 total parachute payments less $40,000 average compensation	$146,640 present value divided by $40,000 average compensation	

EXAMPLE II - Increasing Annual Salary During Base Period and Guarantee of Level Salary During Contract Period

Facts:

- The Account Manager was hired during 1979 at an annual salary of $40,000. Annual salary has increased 10 percent each year during the base period to $64,420 as of January 1, 1984. As in Example I, no other compensation or benefits are provided.
- At the time the change of control occurs, the Account Manager enters into a 5 year employment contract that guarantees continuation of the 1984 salary for the term of the contract. No other compensation arrangements are provided in the employment contract.

Total Parachute Payments	Average Includible Compensation	Safe Harbor Amount	Present Value of Parachute Payments	Excess Parachute Payments	Safe Harbor Needed	% of Total Compensation in Safe Harbor Computation
$322,100	$48,840	$146,520	$236,164	$273,260	4.8X	100%

All payments under the contract	1979	$ 40,000	3 times $48,840 average compensation	1985	$ 60,362	$322,100 total parachute payments less $48,840 average compensation	$236,164 present value divided by $48,840 average compensation
	1980	44,000		1986	52,953		
	1981	48,400		1987	46,447		
	1982	53,240		1988	40,713		
	1983	58,564		1989	35,689		
		$244,204			$236,164		
	Divided by 5 = $48,840						

EXAMPLE III - Guarantee of Employee Benefits

Facts:

- Same salary during the base period as in Example II.
- The Account Manager was covered by employer provided health, accident and life insurance and a qualified pension plan and profit sharing plan during the base period. Employer contributions to such plans averaged 25 percent of base salary per year and were not includible in gross income.
- At the time of the change in control, the Account Manager enters into a 5 year employment contract that guarantees continuation of 1984 base salary of $64,420 during the term. The contract provides for a bonus, but no miminum bonus amounts are guaranteed. The employment contract requires XYZ Corporation to contine the employee benefit plans during the term of the agreement and accelerates vesting under the pension and profit sharing plans. It is assumed that the present value of the guaranteed employee benefits, including the acceleration of vesting, is $50,000.

Total Parachute Payments	Average Includible Compensation	Safe Harbor Amount	Present Value of Parachute Payments	Excess Parachute Payments	Safe Harbor Needed	% of Total Compensation in Safe Harbor Computation
$372,100	$48,840	$146,520	$286,164	$323,260	5.8X	80%
All payments under the contract including fringe benefits	Same as Example II	3 times $48,840 average compensation	Same as Example II plus $50,000 reflecting present value of guaranteed benefits	$372,100 less $48,840 average compensation	$286,164 divided by $48,840 average compensation	

EXAMPLE IV - Stay-On Bonus/Agreement Not to Compete

Facts:

- Same as Example III, except that the Account Manager receives a bonus of 20 percent of salary in 1982 and 30 percent of salary in 1983. In addition, pursuant to the employment agreement entered into at the time of change in control, XYZ Corporation pays the Account Manager on January 1, 1985 a stay-on bonus of $32,210 which is equal to 50 percent of 1984 base salary and the Account Manager executes an agreement not to compete for the term of the agreement.

Total Parachute Payments	Average Includible Compensation	Safe Harbor Amount	Present Value of Parachute Payments	Excess Parachute Payments	Safe Harbor Needed	% of Total Compensation in Safe Harbor Computation
$404,310	$54,484	$163,452	$318,374	$349,826	5.8X	82%
Same as Example III plus stay-on bonus	1979 $ 40,000 1980 44,000 1981 48,400 1982 63,888 1983 76,133 $272,421 Divided by 5 = $54,484	3 times $54,484 average compensation	Same as Example III plus $32,210 stay-on bonus	$404,310 total parachute payment less $54,484 average compensation	$318,374 divided by $54,484 average compensation	

EXAMPLE V - Payments in Cancellation of Stock Options

Facts:

- Same as Example IV except that XYZ Corporation makes payments of $50,000 to the Account Manager in cancellation of 5000 unexercised stock options. The spread betwen the exercise price of the option and the fair market value of the stock as of the change in control is $10 per share.

Total Parachute Payments	Average Includible Compensation	Safe Harbor Amount	Present Value of Parachute Payments	Excess Parachute Payments	Safe Harbor Needed	% of Total Compensation in Safe Harbor Computation
$454,310	$54,484	$163,452	$368,374	$399,826	6.8X	71%
Same as Example IV plus $50,000 stock option payment	Same as Example IV	Same as Example IV	$318,374 in Example IV plus $50,000 stock option payment	$454,310 parachute payments less $54,484 average compensation	$368,374 present value divided by $54,484 average compensation	

EXAMPLE VI - Acceleration of Deferred Incentive Compensation

Facts:

- Same as Example V except that as part of the employment agreement XYZ Corporation accelerates the payment of $50,000 of deferred incentive compensation awarded during the base period. The deferred incentive compensation which was not payable until 1990 is distributed at the time of the change in control.

Total Parachute Payments	Average Includible Compensation	Safe Harbor Amount	Present Value of Parachute Payments	Excess Parachute Payments	Safe Harbor Needed	% of Total Compensation in Safe Harbor Computation
$504,310	$54,484	$163,452	$418,374	$449,826	7.7X	62%
Same as Example V plus $50,000	Same as Example V	Same as Example V	Same as Example V plus $50,000	$504,310 parachute payment less $54,484 average compensation	$418,374 present value divided by $54,484 average compensation	

STATEMENT OF THE ERISA INDUSTRY COMMITTEE

H.R. 1800

The ERISA Industry Committee ("ERIC") is a nonprofit association of over one hundred major corporations doing business in a wide variety of American industries. ERIC's members maintain pension and welfare plans for millions of participants and beneficiaries. ERIC's views are representative of a broad cross-section of major plan sponsors in the private employee benefits community.

RECOMMENDED CHANGES

ERIC recommends that the following changes be made in H.R. 1800:

§ 107(b).—Section 107(b) amends I.R.C. § 467(g) to make clear that it does not apply to any amount to which § 404 or § 404A (or any other provisions specified in regulations) applies. This amendment is appropriate and needed. However, it should be expanded to refer to §§ 83, 419, and 463. Like §§ 404 and 404A, §§ 83, 419, and 463 provide specific rules limiting an employer's ability to deduct expenses associated with various forms of employee benefits. There is no reason to apply section 467(g) to expenses already covered by these provisions.

§ 151(a)(2)(B).—Section 151(a)(2)(B) amends I.R.C. § 419A(d)(1) to provide that it applies to the first taxable year for which a reserve is taken into account under § 419A(c)(2) and to all subsequent taxable years. The Joint Committee Staff's explanation of this amendment indicates (at p. 83) that its purpose is to make clear that the separate accounting requirement with respect to post-retirement medical benefits and post-retirement life insurance benefits does not apply until the first taxable year for which a reserve is computed. The amendment states that § 419A(d)(1) applies to the first such year, but fails to state that it does not apply to prior years. The amendment should be clarified by the addition of the following phrase at the end of the amendment: "but shall not apply to any previous taxable year."

§ 151(a)(3)(A).—Section 151(a)(3)(A) amends I.R.C. § 419A(e) to provide that no reserve may be taken into account for post-retirement medical benefits or life insurance benefits unless the plan meets the requirements of I.R.C. § 505(b), even though the requirements of § 505(b) do not apply to the plan. This amendment should be deleted from the bill; it makes a substantive change in the scope of § 505(b) that is inappropriate in a technical corrections bill.

§ 151(a)(11).—Section 151(a)(11) amends I.R.C. § 4976(b) to extend the 100% excise tax imposed by § 4976 to a benefit provided under a plan that fails to meet the requirements of I.R.C. § 505(b), even though the requirements of § 505(b) do not apply to the plan. This amendment makes a substantive change in the scope of § 4976, and it is inappropriate for inclusion in a technical corrections bill. This aspect of the § 151(a)(11) amendment should be deleted from the bill.

Section 151(a)(11) also amends § 4976(b)(1) to make clear that the separate account requirement applies only to post-retirement benefits and only where a separate account is required by § 419A(d). This aspect of the amendment is appropriate, and should not be deleted.

§ 151(a)(12).—Section 151(a)(12) adds a new paragraph (6) to § 511(e) of the Tax Reform Act of 1984. Paragraph (6) provides, in part, that the Tax Reform Act provisions expanding the application of the tax on unrelated business income are effective for taxable years ending after December 31, 1985. The effect of the amendment is to accelerate significantly the effective date of the Act's unrelated business income provisions. Section 511(e) now provides, in general, that the amendments made by § 511 (including those pertaining to the tax on unrelated business income) apply to contributions paid or accrued after December 31, 1985, in taxable years ending after that date. Although this provision is not well suited to the unrelated business income provisions, it clearly reflects the intention that § 511 should not apply until after December 31, 1985. The proposed amendment would depart from that intention by accelerating the effective date to apply to unrelated business income arising during 1985 in fiscal years beginning in 1985. Because the amendment makes a significant, nontechnical change in the Act, it should either be deleted altogether or modified to eliminate the acceleration that it requires.

§ 152(b)(7).—Section 152(b)(7) amends I.R.C. § 401(a)(20) to provide that a pension plan will not be disqualified under § 401(a) merely because it makes complete distributions to its participants on account of plan termination before the time when they otherwise would be eligible for distributions. Although this amendment appears to be appropriate, it should be expanded to provide that similar distributions under a terminated cash or deferred arrangement will not cause that arrangement to be disqualified under § 401(k). Since the § 401(k) restrictions on distributions were not in-

tended to be more stringent than the § 401(a) restrictions for pension plans (and, in a number of respects, they are less stringent), it is appropriate to refer to cash or deferred arrangements in § 401(a)(20) as well as to pension plans.

RECOMMENDED ADDITIONS

ERIC recommends that the following provisions be added to H.R. 1800:

FUNDED WELFARE PLANS (I.R.C. §§ 419, 419A, 512, 4976)

1. The bill should make clear that post-retirement benefits may be funded at retirement (i.e., under the terminal funding method), rather than over the working lives of the employees.
2. The bill should make clear that once medical care costs for retirees actually increase, the additional costs may be funded on a deductible basis (i) by making an additional lump sum payment, in respect of those already retired, and (ii) by making level payments over the remaining working lives of those still working.
3. The bill should make it clear that the adjustment required by I.R.C. § 419A(f)(7) is taken into account under I.R.C. § 512(a)(3)(E).
4. Paragraph (2) of I.R.C. § 4976(a) should be revised to make it clear that it applies only if a "welfare benefit fund" provides the disqualified benefit.

GROUP-TERM LIFE INSURANCE (I.R.C. § 79)

1. The bill should make clear that, consistent with the nondiscrimination provisions for pension plans, it is not necessary to aggregate all of an employer's group-term life insurance plans in determining whether a particular plan is discriminatory.

EMPLOYEE STOCK OWNERSHIP PLANS (I.R.C. § 404 (k))

1. The bill should amend § 404(k) to make clear that where a plan gives each participant the option to receive current dividend distributions or to have dividends remain in the plan, the employer will be entitled to deduct those dividends that are distributed currently.
2. The bill should amend § 404(k) to make clear that where a plan distributes all of the year's dividends after the close of the year in a single distribution, any earnings on the dividends may be distributed at the same time, and the earnings (like the dividends) will be exempt from the pension withholding requirements.

BELOW-MARKET LOANS (I.R.C. § 7872)

1. The bill should make clear that when a lender is prohibited by local usury laws from charging interest at the applicable Federal rate, the loan will not be treated as a below-market loan.

REQUIRED DISTRIBUTIONS (I.R.C. § 401(4a) (9))

1. The bill should clarify that a "designated beneficiary" under § 401(a)(9) may be (i) a spouse who is deemed to be so designated under §§ 401(a)(11) & 417, (ii) the alternate payee under a qualified domestic relations order, or (iii) a trust. The bill should also clarify that it is permissible for a participant to have more than one designated beneficiary, that the participant is not required to specify in advance the percentage interest of each beneficiary, and that the participant may allow a fiduciary to allocate the benefit under the plan among the designated beneficiaries. In addition, the bill should provide that if a trust is the beneficiary, the beneficiary's life expectancy is determined by reference to the life expectancy or expectancies of the beneficiary or beneficiaries of the trust.

CASH OR DEFERRED ARRANGEMENTS (I.R.C. § 401 (k)

1. The bill should revise I.R.C. § 401(k)(3) to provide that if the plan is maintained pursuant to a collective bargaining agreement, and satisfies the otherwise applicable requirements of I.R.C. §§ 401(a)(4) and 413(b)(2), it need not satisfy the actual deferral percentage test.

ADDITIONAL COMMENT OF THE ERISA INDUSTRY COMMITTEE REGARDING H.R. 1800

§ 153(c)(2).—Section 153(c)(2) amends I.R.C. § 4977 to provide that only employment within the United States will be taken into account in applying the excise tax

on excess fringe benefits. A conforming change should be made in I.R.C. § 132(c)(2) to clarify that only the U.S. operations of an employer should be taken into account in calculating the gross profit percentage for purposes of the employee discount provisions. Virtually all employees who are subject to the employee discount provisions will be employed in their employers' U.S. operations. Thus, in calculating the gross profit percentage, it is appropriate to consider only U.S. operations. If foreign operations were considered, the often significant differences between U.S. and foreign economic conditions are likely to distort the results of the calculation. Moreover, the administrative burden of calculating the gross profit percentage on the basis of foreign operations would be disproportionate to the relatively small number of U.S. taxpayers employed overseas.

H.R. 2110

The ERISA Industry Committee ("ERIC") is a nonprofit association of over one hundred major corporations doing business in a wide variety of American industries. ERIC's members maintain pension and welfare plans for millions of participants and beneficiaries. ERIC's views are representative of a broad cross-section of major plan sponsors in the private employee benefits community.

RECOMMENDED CHANGES

ERIC recommends that the following changes be made in H.R. 2110:

§ 2(a)(1).—To correct clerical errors, "are" should be changed to "is" on line 16, page 2, and line 25, page 3; a closing parenthesis should be added on line 19, page 2, immediately after "consecutive"; and the period should be changed to a comma on line 11, page 4.

§ 2(a)(2).—Section 2(a)(2) amends I.R.C. § 402(e) to provide that in determining whether a distribution that becomes payable on account of separation from service is a lump sum distribution, the balance to the credit of the employee will be determined without regard to any increase in vesting that may occur if the employee is re-employed by the employer; if the employee elects ten-year averaging with respect to the distribution and is later reemployed by the employer and his vested interest in his previously accrued benefits thereby increases, the tax benefits derived by the employee from his election of ten-year averaging are to be recaptured, and the prior election of ten-year averaging is to be disregarded in determining whether the employee may later elect ten-year averaging. The recapture approach would unduly complicate an already complex provision and should be deleted. The problem that the recapture approach addresses is adequately taken care of by the "look-back" rule of § 402(e)(2) and the only-one-election-after-age-59½ rule of § 402(e)(4)(B). However, if the recapture provision is retained, it should be revised to make it clear that the prior lump sum distribution shall not be taken into account under the "look-back" rule. Since the benefits of ten-year averaging with respect to the prior distribution would already have been recaptured, it would be inappropriate to include the prior distribution in the look-back calculation.

§ 2(b)(2)(A)(ii) and (B)(ii).—Section 2(b)(2)(A)(ii) & (B)(ii) amends the transferee plan rules of the Code and ERISA to provide that if separate accounts are maintained for the transferred assets "and any income therefrom," the transferee plan rules apply only to the transferred assets, and not to the other plan assets pertaining to the participant for whom the transfer was made. The amendment should be revised to replace "any income therefrom" with "any income allocable thereto" to avoid any suggestion that the transferred assets must be invested separately; the bill should require separate accounting, not separate investment. In addition, if it is intended to apply the transferee plan rules to both the transferred assets and the income allocable thereto, the amendment should also be revised to state that the rules will "apply only with respect to the transferred assets, *adjusted to reflect any gains or losses allocable thereto*" (new language italicized).

§ 2(b)(4).—Section 2(b)(4) amends the survivor annuity provisions of the Code and ERISA to require a plan to provide that no portion of a participant's accrued benefit may be used as security for a loan without the consent of the participant's spouse. The terms of the amendment indicate that the spousal consent requirement will not apply to a plan (e.g., a profit-sharing or stock bonus plan) that is exempt from the survivor annuity provisions by reason of I.R.C. § 401(a)(11)(B)(iii) & (C) and ERISA § 205(b)(1)(C) & (2). This is so because exempt plans are not subject to the provisions of I.R.C. § 417 and ERISA § 205 in which the loan provisions will appear. However, to eliminate any possible misunderstanding, the Committee's report should state explicitly that exempt plans are not subject to the loan provisions. (Any other result

would make no sense, since a participant may make a withdrawal from an exempt plan without obtaining spousal consent.)

The amendments should also be revised to make it clear (i) when spousal consent must be given (presumably, when the security interest is given—which is not necessarily at the same time that the loan is made), (ii) that, once given, a spouse's consent may not be revoked, and (iii) that a consent given by one spouse is binding on a subsequent spouse.

To correct a clerical error, "subsection (c)(1)(C)" should be changed to "subsection (a)(1)(C)" on line 6, page 11.

Section 2(b)(4) applies to loans made after April 18, 1985. This early effective date (the date on which H.R. 2110 was introduced) is unreasonable and should be postponed. Plan administrators cannot reasonably be expected to be able to comply with the new spousal consent provisions imposed by § 2(b)(4) as early as April 19, 1985. The effective date should give plan administrators a sufficient amount of time, after the bill is enacted, to learn about the new provision, to understand it, and to change their administrative procedures to comply with it. Accordingly, § 2(b)(4) should become effective no earlier than six months after the date of enactment of H.R. 2110.

§ 2(b)(5).—Section 2(b)(5) amends I.R.C. § 417(a)(3)(B) and ERISA § 205(c)(3)(B) to extend the period for providing an explanation of the preretirement survivor annuity in the case of a participant who is hired after the close of the plan year preceding the plan year in which he attains age 35. In order to clarify its meaning, the amendment should be revised as follows: "in which the participant attains age 35, or, if *the participant is hired after the close of the plan year preceding the plan year in which the participant attains age 35 (or within less than a reasonable period before such date),* within a reasonable period after the participant is hired" (new language italicized).

§ 2(b)(6).—Section 2(b)(6) amends the spousal consent requirements that govern an election to waive a survivor annuity by providing that either (i) the participant's election must designate a beneficiary that may not be changed without the spouse's consent or (ii) the consent of the spouse must permit the participant to designate beneficiaries without any requirement of further spousal consent. The amendment fails to address the common situation in which the participant's election involves no beneficiary at all—for example, where the participant elects a single life annuity in lieu of a qualified joint and survivor annuity or where the participant declines the qualified preretirement survivor annuity and foregoes any preretirement death benefit under the plan. The amendment also does not specify whether, after the spouse has consented to the participant's election, the participant may change the form of the plan benefit without being required to obtain further spousal consent. These flaws could be remedied by revising the amendment to read, in part, as follows: "Such election designates a benefit option and, if applicable, a beneficiary, neither of which may be changed without spousal consent (unless the consent of the spouse permits changes in the benefit option, beneficiary, or both by the participant without any requirement of further consent by the spouse)".

The amendment should also provide that a plan may require either that all spousal consents must be restricted (i.e., limited to the particular benefit option and beneficiary (if any) elected) or that all spousal consents must be unrestricted (i.e., permitting subsequent changes without further consent by the spouse). This rule should be effective as of August 23, 1984. (If, contrary to our recommendation, a more restrictive rule is adopted, the new, more restrictive rule should apply only to consents given at least six months after the enactment of H.R. 2110.)

§ 2(c)(1).—Section 2(c)(1) provides that where distributions are made to an alternate payee under a qualified domestic relations order, the distributions shall be included in the gross income of the alternate payee only where the alternate payee is the participant's spouse or former spouse; otherwise the distributions are included in the participant's gross income. This provision makes a substantive, nontechnical change in the law, and should be deleted. The REA made clear that the alternate payee is to be charged with receipt of the distributions made pursuant to a qualified order, regardless of whether the alternate payee is the participant's spouse. The proposed change makes a substantive change in this rule, and it will now be difficult to explain to participants why they are being taxed on income that they do not receive. Because the current law is easy to explain and to administer, it should not be changed. In any event, if the law is changed, conforming changes should be made in I.R.C. § 72(m)(10) (which requires the allocation of the participant's after-tax contributions among all alternate payees) and I.R.C. § 402(a)(1) (which requires plan distributions to be charged to the "distributee").

§ 2(c)(2)(i).—To correct two clerical errors, line 5 on page 16 of the bill should be revised to read: "order determined to be qualified domestic."

§ 2(c)(2)(iv).—To correct a clerical error, "beginning" should replace "beginning" on line 9 of page 17. In addition, in order to make the amendment more accurate, "on" should be deleted and replaced with "as of" in line 9 on page 17; the same change should be made in line 19 on page 18.

§ 2(c)(4)(A)(v).—Section 2(c)(4)(A)(v) amends I.R.C. § 414(p) to provide that the fact that a plan makes a payment to an alternate payee will not cause the plan to fail to meet the requirements of I.R.C. § 401(a) & (k) prohibiting payment of benefits before termination of employment. The amendment further provides that the foregoing protection against a court-ordered violation of § 401(a) or (k) will not apply if the present value of the payments to the alternate payee exceeds $3,500.

This provision should refer to I.R.C. § 409(d) as well as to § 401(a)(k). See S. Rep. No. 575, 98th Cong., 2d Sess. 21 (1984).

The $3,500 limitation is wholly inappropriate and should be deleted. REA's qualified domestic relations order provisions clearly contemplate that a qualified order may require the payment of benefits before the participants has terminated employment. There is no justification for disqualifying a plan merely because it has observed the terms of a qualified domestic relations order.

The Joint Committee staff's description of H.R. 2110 indicates that this provision is intended to apply to a distribution that is made before the participant has either separated from service or attained the earliest retirement age under the plan. Section 2(c)(4)(A)(v) makes no reference to the plan's earliest retirement age and thus does not accomplish what the staff believes to have been intended. If the bill is revised to reflect this intention, corresponding changes should be made in the definition of a qualified order in I.R.C. § 414(p)(4) and ERISA § 206(d)(3)(E), which delineate the extent to which a qualified order may require payments not provided for under the plan. If these changes are not made, an order that requires a payment before the plan's earliest retirement age will not be a qualified order.

ERIC supports the Treasury Department's recommendation regarding § 2(c)(4)(A)(v): the provision should state that a plan may make payments to an alternate payee before the participant either separates from service or attains the plan's earliest retirement age if (i) a qualified order directs that the payments be made and (ii) the plan itself authorizes the payments.

§ 2(d).—To correct a clerical error, " 'qualifying rollover distribution' " should replace " 'qualified rollover distribution' " in § 2(d)(1). A conforming change should be made in the heading of I.R.C. § 6652(j) by replacing "Certain Qualifying Rollover Distributions" with "Eligible Rollover Distributions."

§ 2(f)(1).—Section 2(f)(1) amends REA § 303(c) to provide that in the case of a participant who is covered by a qualified preretirement survivor annuity pursuant to the transition rule set forth in REA § 303(c)(2), "the amount of any death benefit" payable to any beneficiary shall be reduced by "the amount payable to the surviving spouse" by reason of § 303(c)(2). In the interest of accuracy, the references in this provision to "the amount" of certain benefits should be changed to "the present value" of those benefits.

As drafted, the amendment requires a plan to offset the survivor annuity against the other death benefit. There is no apparent reason why a plan should be compelled to make this reduction. It should be sufficient to give each plan the option to make the reduction and to make it clear that a plan will not be disqualified under I.R.C. § 401(a) if it exercises this option.

In addition, the wording of the amendment suggests that a preretirement survivor annuity will be paid pursuant to REA § 303(c)(2). In fact, the annuity will be paid pursuant to plan provisions that comply with § 303(c)(2). The amendment should be revised to reflect this fact.

Finally, § 2(f)(1) should be expanded to include any participant described in REA § 303(c)(2)(A) & (B) who (i) is a participant in a plan that is amended, during the first plan year to which the REA amendments apply, to exempt it from the survivor annuity provisions, and (ii) dies on or after the date of enactment of REA and on or before the date the plan amendment is adopted.

RECOMMENDED ADDITIONS

ERIC recommends that the following provisions be added to H.R. 2110:

ANTICUTBACK RULE (I.R.C. § 411(d)(6); ERISA § 204(g))

1. The bill should make clear that an alternative form of payment that is available only in the discretion of the plan administrator or a plan fiduciary is not an

"optional form of benefit" for purposes of the anticutback rule. Likewise, the bill should make clear that the exercise of discretion under such a provision is not an amendment of the plan for purposes of the anticutback rule.

2. The bill should make clear that a plan amendment that eliminates the subsidy under a subsidized qualified preretirement survivor annuity does not reduce the participant's accrued benefit for purposes of the anticutback rule.

3. The bill should make clear that the anticutback rule does not prevent a plan from being amended to reduce benefits to reflect the cost of providing the qualified preretirement survivor annuity.

MATERNITY/PATERNITY LEAVE (I.R.C. §§ 410(a)(5), 411(a)(6); ERISA §§ 202(b)(5), 203(b)(3))

1. The bill should make it clear that a plan that uses the elapsed time method (and which therefore already credits service for any absence of up to one year) is not required to credit additional service pursuant to REA's maternity/paternity leave provisions.

QUALIFIED SURVIVOR ANNUITIES (I.R.C. §§ 401(a)(11), 417; ERISA § 205)

1. The bill should amend the exception for profit-sharing and stock bonus plans to permit such plans to impose a one-year-of-marriage requirement without losing their eligibility for the exception. The bill should also make clear that I.R.C. § 401(a)(11)(B)(iii)(II) and ERISA § 205(b)(1)(C)(ii) do not require such plans to allow participants to elect life annuities.

2. The bill should clarify three aspects of the special rule regarding the qualified preretirement survivor § 417(c)(2) and ERISA § 205(e)(2). First, the bill should make clear that the value of the participant's account balance may be adjusted for investment gains and losses occurring between the participant's date of death and the valuation date used to determine the amount of the annuity. Second, the bill should clarify when the survivor annuity must begin. Third, the bill should make clear that only the vested portion of the participant's account balance is taken into account under the special rule.

3. The bill should clarify the definition of "annuity starting date" in I.R.C. § 417(f)(2) and ERISA § 205(h)(2) by referring to "termination of employment" as well as to "retirement" and "disability."

4. The bill should make clear that a plan may presume that every participant is married, and may charge for the cost of preretirement survivor annuity protection, until and unless the participant waives the coverage in advance.

5. The bill should provide that when a participant files an effective waiver of qualified preretirement survivor annuity coverage, the plan may rely on the waiver until notified in writing that the participant has remarried.

6. The bill should make clear whether an election to waive the qualified joint and survivor annuity before the beginning of the applicable election period is valid. This is not made clear by I.R.C. § 417(a)(1)(A) and ERISA § 205(c)(1)(A).

7. The bill should make clear that since the qualified preretirement survivor annuity rules applied before the generally applicable effective date of REA, a plan may pass on the cost of the preretirement survivor annuity coverage during the pre-effective-date period automatically to all participants.

8. In many countries, the position of "notary public" does not exist. The bill should provide that in the case of a spousal consent executed outside of the United States, the consent may be witnessed by the equivalent of a notary public in the country where the consent is executed (as well as by a plan representative).

9. The bill should clarify that a plan may require a preretirement survivor annuity to begin as of the month next following the participant's death (or, if later, as of the month in which the participant would have attained the earliest retirement age under the plan).

10. The bill should correct a technical error in I.R.C. § 417(c)(1)(B) and ERISA § 205(e)(1)(B) by providing that if the participant dies after the earliest retirement date under the plan, the earliest period for which the surviving spouse may receive a payment under the qualified preretirement survivor annuity is the month following the month of the participant's death.

11. The bill should make clear that, in determining the size of the payments under a qualified joint and survivor annuity or a qualified preretirement survivor annuity, a plan may presume that the spouse's age is identical to that of the employee and may place the burden on the employee to prove otherwise.

12. The bill should amend REA § 303(e)(4)(A)(ii) to provide that a plan will not be deemed to fail to give notice before the Treasury fulfills its obligation to provide guidance on how to give notice under § 303(e)(4)(A)(i).

QUALIFIED DOMESTIC RELATIONS ORDERS (I.R.C. §§ 401(a)(13), 414(p); ERISA § 206(d))

1. The bill should make clear that a plan is bound by a qualified domestic relations order only if the plan has been made a party to the litigation and the court has jurisdiction over the plan.

2. The bill should amend I.R.C. § 414(p)(7)(C) and ERISA § 206(d)(3)(H)(iii) to make clear that a plan administrator may, in its discretion, refrain from paying the segregated amounts until the expiration of the 18-month period, even if it is determined that the order is not a qualified domestic relations order. This would confirm that the plan administrator has the authority to suspend payment, in its discretion, if it has reason to believe that the order may be amended within the 18-month period to cure any defect that originally prevented the order from qualifying.

CASH-OUTS (I.R.C. § 411(a)(11)(a); ERISA § 203(e)(1))

1. The bill should clarify that the bar against the immediate mandatory distribution of the present value of a benefit that exceeds $3,500 does not apply to a defined contribution plan.

2. The bill should clarify that the bar against the immediate mandatory distribution of the present value of a benefit that exceeds $3,500 applies only to lump sum distributions and not to annuity or installment distributions.

3. The bill should clarify that accumulated deductible employee contributions are disregarded when applying the $3,500 limit.

NOTICE OF FORFEITABILITY OF BENEFITS (I.R.C. § 6057; ERISA § 105)

1. The bill should clarify whether the required notice that benefits are forfeitable must be included in the statement of total accrued benefits and nonforfeitable accrued benefits furnished to plan participants who have not separated from service. Cf. H.R. Rep. No. 655, 98th Cong., 2d Sess. (Part 2) 3, 23 (1984); S. Rep. No. 575, supra, at 24–25.

WOODCLIFF LAKE, NJ, *May 21, 1985.*

JOSEPH DOWLEY, Esq.,
Chief Counsel, Committee on Ways and Means, House of Representatives, Washington, DC.

DEAR MR. DOWLEY: I previously requested to testify on the need for technical corrections to Section 108 of the Tax Reform Act of 1984. However, on May 13, 1985, the Tax Court rendered a decision in the *Miller* case, 84 T.C. No. 55, which nullified certain parts of the IRS proposed temporary regulations under that section. Due to the release of this decisions, I cancelled my request to testify. I am, however, enclosing a copy of my outline which I had planned to use if I testified.

The reason that I wanted to appear is that I believe the IRS is unreasonable in ignoring the intent of Congress. The IRS not only issued regulations under Section 108 which contradicted the intent of Congress but they also refused to dismiss and/or settle pending cases. In addition, they refused to allow anyone to use the presumption of profitability.

The *Miller* case stated that "The temporary regulations are plainly inconsistent with Section 108 as so construed in accordance with its legislative history; the regulations insofar as they adopt the *Smith-Fox* test are invalid."

The *Miller* case, in footnote 22, discusses the presumption contained in Section 108(b). The Court ruled in favor of the taxpayer without having to look to the presumption. However, the Court stated that "The temporary regulations established requirements which are not suggested either by the legislative language or committee report."

There is still uncertainty in this area and the uncertainty may continue for a number of years. The IRS may appeal this *Miller* case. The IRS may not change instructions to their agents and appellate conferees and therefore there will be no settlements.

The IRS must untie the hands of their agents and appellate conferees. If the IRS continues with its present position it will only lead to additional court backlogs.

You may still wish to consider the two technical amendments I refer to in my outline. There is still a need for certainty in this area.

Very truly yours,

LAWRENCE A. GARBER.

OUTLINE OF PROPOSED COMMENTS

I. Purpose:

A. I am appearing today to request that technical amendments be made to Section 108 of the Tax Reform Act of 1984.

B. Section 108 is entitled "Treatment of Certain Losses on Straddles Entered Into Before Effective Date of Economic Recovery Act of 1981."

II. My background:

A. Former tax partner of the "Big Eight" accounting firm Arthur Andersen & Co. where I was in charge of commodity tax practice.

B. I am an active member of the N.Y. Bar Association's Committee on Commodities—although I am not speaking on their behalf.

C. Prior to 1981, I participated in many IRS audits of commodity transactions.

D. I continue to consult with many former clients regarding their audits of transactions that occurred in the 1970's.

E. I am presently the president of a commodity trading advisory firm.

F. I consult with my clients in connection with IRS audits of their commodity transactions.

G. I have personally been debating with the IRS regarding the proper tax consequences of my own commodity transactions going back to 1978.

III. The conference agreement report, regarding section 108, stated that "The conferees believe it is inappropriate to prolong the uncertainty with respect to . . . straddles."

IV. Section 108 allows straddle losses if ". . . such position is part of a transaction entered into for profit. There is also a presumption of profitability for two types of commodity traders."

V. The conference agreement report and the general explanation report prepared by the staff of the Joint Committee on Taxation both stated that:

A. In determining whether the position is part of a transaction entered into for profit, it is intended that the provision be applied by treating the condition as satisfied if there is a reasonable prospect of any profit from the transaction.

B. This is an objective test in that it looks to the transaction itself to see if there was a reasonable prosespect for any profit.

VI. The IRS has issued proposed temporary regulations:

A. These regulations use a primarily for profit standard rather than a reasonable prospect of any profit from the transaction.

B. The IRS regulations use a subjective test in that it requires an examination of the specific intent of a taxpayer.

VII. I would like to report on the status of IRS examinations:

A. This report is based upon my discussions with tax partners in "big eight" accounting firms, tax lawyers practicing in the commodity area and commodity exchange officials.

B. This report is also based upon my discussions with IRS appellate conferees, IRS group managers, and IRS agents.

VIII. I believe that one of the intents of Congress was to clear up the tax court backlog of commodity tax cases:

A. This has not occurred.

B. As a matter of fact, due to the IRS' apparent ignoring of the intent of Congress, the backlog has increased.

IX. The IRS issued news release IR-84-91 at the time it issued its proposed temporary regulations:

A. The News release referred to section 108 as a "taxpayer relief provision."

B. The news release also said that "The IRS announced that it is reviewing pending cases of persons who may qualify for the presumption to determine which cases should be closed out by settlement or otherwise."

X. Based upon my discussions with the various groups I mentioned, I believe that the IRS has not granted relief to anyone and has not applied the presumption to anyone:

A. IRS agents say that their "hands are tied" and they are under instructions to disallow all straddle losses.

B. IRS group chiefs and managers say the same thing.

C. IRS appellate conferees say the same thing and add that they are instructed to get rid of all pending cases by issuing disallowance reports.

D. The above is leading to an even greater tax court backlog than that which existed before the enactment of section 108.

XI. Former Treasury officials Fred Hickman and Don Lubick have assailed the IRS' proposed temporary regulations. They said:

A. The ". . . regulations reflect a course of treasury action that is unprecedented and threatening to the tax system."

B. "The regulations . . . flatly contradict the language of the statute and the committee report."

C. "A taxpayer taking similar liberties with the legislative language . . ." would be assessed "negligence penalties."

XII. I would like the committee to consider the following two technical corrections to section 108:

A. Where section 108 refers to "for profit," the phrase "reasonable prospect of any profit from the transactions" be substituted.

B. Where section 108 refers to a presumption for dealers and persons actively engaged in investing in regulated futures contracts that the word any be inserted before regulated futures contracts.

GROOM & NORDBERG,
Washington, DC, May 28, 1985.

Re May 16 hearing on H.R. 1800; Participation of full-time life insurance salesmen in cafeteria plans.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means, House of Representatives, Washington, DC.

DEAR MR. CHAIRMAN: This comment on H.R. 1800, the Technical Corrections Act of 1985, relates to the ability of full-time life insurance salesmen ("FTLIS") to participate in cafeteria plans. FTLIS are independent contractors who are affiliated with a life insurance company and who primarily promote the life insurance and annuity products of that insurer. Under the Internal Revenue Code (the "Code"), FTLIS are treated as common law employees of the insurer for purposes of a number of statutory employee benefits, including many of the nontaxable benefits that may be offered as part of a cafeteria plan. Thus, the effect of FTLIS classification is to permit these independent contractors to participate in employee benefit programs that are otherwise limited to common law employees of the insurer. A life insurance company may have up to several thousand FTLIS.

We respectfully request that H.R. 1800 include a provision to confirm that FTLIS may participate in a cafeteria plan if their selection of benefits is limited to taxable benefits and those nontaxable benefits for which they are deemed employees by statute. This change will prevent the anomalous result of a FTLIS who participates in a health program from being denied continued coverage under that same program merely because it is offered as part of a cafeteria plan.

Many large life insurance companies would like to implement a cafeteria plan in the near future to restrain escalating health costs. Because of considerations of equity, employee relations, and administrative costs, these companies want to treat FTLIS and common-law employees equally for employee benefit purposes. However, the Deficit Reduction Act of 1984 ("DEFRA") has generally been viewed as congressional ratification of the Treasury Department's proposed regulations governing cafeteria plans. Those regulations do not specifically refer to FTLIS, but cast doubt on the ability of FTLIS to participate in cafeteria plans to even the limited extent noted above. Moreover, at this point, it is highly unlikely that final regulations pertaining to cafeteria plans will be forthcoming in the near future.

This technical issue is thus of major concern to many large life insurance companies. We therefore believe it would be an appropriate technical correction to confirm that FTLIS may continue to be treated as employees for certain employee benefit purposes where those benefits are part of a cafeteria plan.

DISCUSSION

1. Background

A "full-time life insurance salesman" is defined by the regulations as an individual who, among other things, sells insurance or insurance products primarily for

one insurance company.[1] Even though a FTLIS is not an "employee" of his or her affiliated insurance company under common law, section 7701(a)(20) of the Code provides that a FTLIS, as defined in the Social Security tax rules,[2] is deemed to be an employee for purposes of certain benefits provisions, and thus may participate in those benefit programs along with common law employees of the insurer.

Among the benefits for which a FTLIS is treated as an employee by section 7701(a)(20) are (1) group-term life insurance, (2) accident and health plans, and (3) qualified pension, etc., plans, including cash or deferred arrangements. Thus, FTLIS are treated as employees for purposes of all of the nontaxable benefits that may be offered under a cafeteria plan except for group legal services (under section 120) and dependent care assistance (under section 129). The failure to specifically include FTLIS under sections 120 and 129 does not appear to reflect any congressional intent to restrict the participation of FTLIS in benefit programs. Rather, it appears that, in adding new forms of nontaxable benefits under sections 120 and 129, Congress simply overlooked the need to make corresponding amendments to section 7701(a)(20).[3]

Section 125 of the Code does not itself define the term "employee" for purposes of the cafeteria plan rules, but Q&A 4 of the proposed regulations does. The definition provides, in pertinent part, that "[t]he term 'employees' does not, however, include self-employed individuals described in section 401(c) of the Code." Although FTLIS are self-employed individuals, they are also "statutory employees" under section 7701(a)(20) of the Code. However, the proposed regulations could be interpreted to imply that FTLIS may not be treated as employees for purposes of section 125 of the Code, and thus may not participate in a cafeteria plan.

DEFRA generally is considered to have ratified these proposed regulations governing cafeteria plans. It is important, therefore, that the technical corrections bill remove any implication that DEFRA ratified a definition of "employees" that precludes FTLIS from participating in a cafeteria plan. We understand that many large life insurance companies are concerned over this issue.

2. It should be confirmed that FTLIS may participate in a cafeteria plan if their selection of benefits is limited to cash and those benefits for which they are already considered employees under current law

We request confirmation that FTLIS may participate in a cafeteria plan if their selection of benefits is limited, by the terms of the plan, to taxable benefits and those nontaxable benefits for which they are already considered employees of their affiliated insurance company. For example, if a cafeteria plan maintained by an insurance company generally allows employees to choose among cash, group-term life insurance, medical insurance, group legal services, and dependent care, FTLIS should be permitted to participate if they may select any of those benefits except group legal services or dependent care.

In our view, such confirmation is consistent with section 125 and its legislative history. While the legislative history of section 125 states that plan participation is limited "to individuals who are employees," [4] the statute itself does not define the term "employee." Moreover, the adoption of our recommendation would in no way expand upon the benefits that an insurance company can provide to its FTLIS, or alter the tax treatment of those benefits when provided to a FTLIS. The confirmation would simply clarify that the constructive receipt principle of section 125 allows FTLIS to choose between taxable benefits and those nontaxable benefits that FTLIS are currently permitted to receive in the absence of a cafeteria plan.

We emphasize that the failure to confirm that FTLIS may participate in cafeteria plans to the limited extent suggested will impose needless additional benefit and administrative costs on insurance companies. For example, one major reason why life insurance companies (like many other employers) would consider implementing a cafeteria plan is to mitigate the impact on employees of health care cost saving measures (such as higher deductibles and copayments) that are being considered in connection with an insured health plan. If, however, a significant portion of its work force currently participating in its health plan (*i.e.*, several thousand FTLIS) are unable to participate in the cafeteria plan, an insurer may be reluctant to imple-

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[1] See Treas. Reg. § 31.3121(d)-1(d)(3)(ii).

[2] Another important consequence of FTLIS status is that a FTLIS is treated as an employee, rather than a self-employed individual, for purposes of the Social Security tax rules. See Code §3121(d)(3)(B).

[3] Section 7701(a)(20) was last amended in 1964 in connection with the enactment of the group term life insurance rules of section 79.

[4] S. Rep. No. 1263, 95th Cong., 2d Sess. 75 (1978).

ment its health care cost containment objectives with respect to the ineligible group of FTLIS. In addition to perpetuating higher benefit costs, another significant effect of maintaining separate benefit programs for FTLIS and regular employees would be the administrative burdens and costs associated with the operation of multiple plans for different segments of its work force.

There is no apparent reason why FTLIS should be denied the opportunity to select among the benefits for which they are otherwise eligible according to their individual needs and circumstances. Indeed, the recommended confirmation would be consistent with a major objective of section 125—to facilitate the more effective delivery of employee benefits that are otherwise permitted under the Code and provided by an employer.

For all of the foregoing reasons, we respectfully request that H.R. 1800 include a provision to confirm that FTLIS may participate in a cafeteria plan of an insurance company (with respect to which they have FTLIS status), but only if FTLIS are eligible to select solely among taxable benefits and the nontaxable benefits for which they are considered (under section 7701(a)(20)) employees of the insurance company.

Following is a draft of sample statutory language that could be used to confirm the treatment of FTLIS as we suggest:

Section 7701(a)(20) is amended by inserting the following language immediately after "employees' death benefits,": "for the purpose of applying the provisions of section 125 with respect to cafeteria plans (but only with respect to qualified benefits, as defined in section 125(f), which are either described in this paragraph or are subject to tax under subtitle A)".

You will note that the above language presupposes that section 153(b)(1) of H.R. 1800 will be enacted and will amend Code section 125 such that cafeteria plans will be limited to the provision of "qualified benefits."

Thank you for your consideration of this issue. If you or your staff have any questions or comments, please feel free to call either of the undersigned persons.

Very truly yours,

LOUIS T. MAZAWEY,
DOUGLAS W. ELL.

STATEMENT OF HAYNSWORTH, PERRY, BRYANT, MARION & JOHNSTONE, ATTORNEYS FOR COLOSSEUM ASSOCIATES, A LIMITED PARTNERSHIP

Colosseum Associates is a limited partnership organized for the purpose of financing the development, construction, and operation of a coliseum in the Greenville area.

Section 31(g) of Public Law 98-369 (the "Act") provides as follows:

(4) OFFICIAL GOVERNMENTAL ACTION ON OR BEFORE NOVEMBER 1, 1983.—

(A) IN GENERAL.—The amendments made by this section shall not apply with respect to any property leased to a tax-exempt entity (other than the United States, any agency or instrumentality thereof, or any foreign person or entity) if—

(i) on or before November 1, 1983, there was significant official governmental action with respect to the project or its design, and

(ii) the lease to the tax-exempt entity is pursuant to a written binding contract entered into before January 1, 1985, which requires the tax-exempt entity to be the lessee of the property.

(B) SIGNIFICANT OFFICIAL GOVERNMENTAL ACTION.—For purposes of subparagraph (A), the term 'significant official governmental action' does not include granting of permits, zoning changes, environmental impact statements, or similar governmental actions.

It is our understanding that the above-cited provision was to have the net effect of exempting the Greenville coliseum (the "coliseum") from the tax-exempt leasing provisions of the Act. Colosseum Associates were formed, and a binding contract for financing, development, and operation of the coliseum was entered into, based upon this understanding.

In reviewing Minutes of meetings of the Greenville County Auditorium Board before November 1, 1983, we have determined that the type of significant governmental action discussed in the legislative history to Section 31(g) of the Act did, in fact, take place. However, on November 2, 1982, a county-wide referendum was held to vote on public financing for the coliseum. This referendum was a negative referendum, i.e., the proposed financing for the coliseum was defeated. Thereafter, the Auditorium Board continued to meet and came up with a different plan of financing which has resulted in the original decision to build the coliseum being confirmed,

albeit with a different financing structure. The Auditorium Board also decided that a different site should be selected.

While Act Section 31(g)(4)(A)(i) discusses significant official governmental action with respect to the *project*, the legislative history discusses how such action relates to: (i) "property constituting part of a project," (ii) "particular property [as] part of an approved project," (iii) "the project," (iv) "a particular project," and (v) "the property."

In order to avoid any possible confusion, we request that Act Section 31(g)(4) be amended to read as follows:

> (A) IN GENERAL.—The amendments made by this section shall not apply with respect to any property leased to a tax-exempt entity (other than the United States, any agency or instrumentality thereof, or any foreign person or entity) if—
>
> (i) on or before November 1, 1983, there was significant official governmental action with respect to the project or its design, and
>
> (ii) the lease to the tax-exempt entity is pursuant to a written binding contract entered into before January 1, 1985, which requires the tax-exempt entity to be the lessee of the property.
>
> (B) SIGNIFICANT OFFICIAL GOVERNMENTAL ACTION.—For purposes of subparagraph (A), the term 'significant official governmental action' does not include granting of permits, zoning changes, environmental impact statements, or similar governmental action. *Significant official governmental action is not withdrawn by a negative referendum on financing if the appropriate governing body evidences intent to proceed with the same project, even if the project is to be financed by means other than those originally contemplated by the significant official governmental action.*
>
> (C) *DEFINITION OF PROJECT.—The term "project" is to be applied in its broadest possible sense in order to facilitate the purposes of the transitional rule. For example, the term "project" would include the financing and building of a coliseum or other building, even though the exact size or location of such coliseum or building within a defined community has varied over time, so long as the governing body which will, in fact, operate such coliseum or building in the same governing body which approved that coliseum or building in the first instance.*

The approval and inclusion of this clarification concerning the Greenville coliseum in the pending Technical Corrections Act of 1985 is respectfully requested.

STATEMENT OF HAYNSWORTH, PERRY, BRYANT, MARION & JOHNSTONE, GREENVILLE, SC, ATTORNEYS FOR THE UNIVERSITY AND PROPERTY DESCRIBED IN SECTION 31(g)(17)(H) OF THE DEFICIT REDUCTION ACT OF 1984

The Deficit Reduction Act of 1984 (the "Act") in Subtitle B—Tax-Exempt Entity Leasing, Section 31, subsection (g) EFFECTIVE DATES, paragraph (17) CERTAIN TRANSITIONAL LEASED PROPERTY, subparagraph (H) provides as follows:

> (H) Property is described in this subparagraph if such property is used by a university, and
>
> (i) in July 1982, the Board of Trustees of the university adopted a master plan for the financing of the property; and
>
> (ii) as of August 1, 1983, at least $60,000 in private expenditures had been expended in connection with the property.

It is our understanding that the above-cited provision was to have the net effect of exempting a specific project (the "property") at a specific University from the tax-exempt leasing provisions of the Act. The property includes an Institute dedicated to the study and advancement of public affairs. The property also includes a continuing education center, a performing arts center, a golf course, and a housing project.

In reviewing the master plan adopted by the University's Board of Trustees in July 1982 relating to the property, the law firm of Haynsworth, Perry, Bryant, Marion & Johnstone, counsel to the University and the property, has determined that, although financing was discussed, the master plan was principally a comprehensive plan for the development of the property. Moreover, we determined that the sums expended by the private sector in connection with the property were principally related to the development of a comprehensive plan for such property. Therefore, to avoid any possible confusion, we request that subparagraph (H) be amended to read as follows:

> (H) Property described in this subparagraph if such property is used by a university, and

(i) in July 1982, the Board of Trustees of the university adopted a master plan for the financing and development of the property; and

(ii) as of August 1, 1983, at least $60,000 in private expenditures had been expended in connection with the development of a master plan for the property.

The approval and inclusion of this clarification to the Act in Section 31(g)(17)(H) concerning the property in the pending Technical Corrections Act of 1985 is respectfully requested.

STATEMENT OF FRANK L. JENSEN, JR., EXECUTIVE DIRECTOR, HELICOPTER ASSOCIATION INTERNATIONAL

Mr. Chairman and members of the subcommittee, I am pleased to comment on behalf of the commercial helicopter industry regarding H.R. 1800.

The Helicopter Association International (HAI) is an independent, non-profit organization formed in 1948. Our regular members are civil companies and organizations which operate helicopters. Our associate members are the manufacturers of helicopters, engines, components and ancillary equipment, as well as suppliers, brokers, insurers and service organizations. About eighty percent of HAI's membership is from the United States, and the remainder is from forty nations around the world. There are also affiliate members, primarily regional helicopter associations, and sustaining members, for a total of nearly 1,100 members. HAI provides a unique and valuable forum for the entire civil helicopter industry.

HAI's regular members operate helicopters in the fields of agriculture, air carrier, air taxi, construction, corporate transport, electronic news gathering, executive transport, fire control, forestry, and law enforcement, among many other important uses. The helicopters operated by HAI's regular members range from small two-place machines powered by a single 200-horsepower reciprocating engine, to the free world's largest commercial helicopter which carries 44 passengers and a crew of three, and has two turbine engines, each with more than 4,000 horsepower. In all, there are more than 9,000 civil helicopters in operation within the U.S. at this time.

As a convenient reference I would like to cite the 1985 Helicopter Annual, which is a 272-page, four-color industry overview published by HAI. Copies were provided with this statement [retained in committee files], and additional copies are available upon request from HAI.

HELICOPTERS IN THE OFFSHORE PETROLEUM INDUSTRY

Helicopters are the only economical transportation vehicle serving the petroleum exploration and production industry in the Gulf of Mexico, Californian and Alaskan waters. The remote and isolated nature of this industry dictates so.

Due to this remoteness, little if any Federal funds have been expended towards facilities supporting these helicopter operations which transport an estimated 200,000 American petroleum workers a month. Typically, all flight following, weather observations and navigational equipment is provided and paid for by private industry. What little Federal assistance is offered is in the form of an operator initiated radio position report sent in to the Houston Air Traffic Control Center, which then tracks the various aircraft by the "strip" method. No radar or positive control separation is provided. In fact, when Houston Center gets too busy with other traffic, such as fixed-wing air carrier operations, they will not accept additional helicopter requests for flight following.

Therefore, the operator is better off establishing his own in-house flight following system, with operator developed Airborne Radar Approaches utilizing on-board weather radar equipment to complete the descent and landing at the offshore structure. Any navigational aids, such as non-directional beacons that one finds offshore today, are also privately paid for and supported. It is estimated that less than 10% of all flights in the Gulf of Mexico initially utilize Federal facilities (meaning the radio position tracking provided by Houston Center) and of that 10%, a small portion of the actual flight is spent in communications with the air traffic center.

SUPPORT FOR H.R. 1800

The HAI supports H.R. 1800 for reasons of justice, economics and safety. The excise tax is a user fee and, justifiably, those who use the Federally funded facilities should pay the excise tax for that use. Injustice, however, arises when helicopter operators, who never use the system, are obligated to pay the use tax. H.R. 1800 is a step in correcting this injustice.

Helicopter operators, especially those operating offshore who cannot utilize Federally funded airways or heliports, frequently provide their own facilities and navigational aids. Until H.R. 1800 becomes effective, those citizens in petroleum production, who of necessity pay for private installations, are required to pay additionally for Federal service they do not use.

Finally, safety is a factor. HAI suggests that resources needed for helicopter flight safety be utilized where those flights occur. If Federally funded facilities do not meet the needs of certain classifications of helicopter flights, then the resources should be released to the individual operator, through exemptions like that which is included in H.R. 1800, so that those resources may be used to purchase instruments and facilities that enhance safety for that classification of helicopter flights.

HAI respectfully submits that H.R. 1800 is the correct interpretation of the excise tax exemption for certain helicopter uses, which exemption was originally brought into law through H.R. 4170.

HELLER, EHRMAN, WHITE & MCAULIFFE,
San Francisco, CA, May 28, 1985.

Re Proposed amendment to section 555 of 1984 Tax Reform Act (relating to incentive stock options) contained in section 155 of H.R. 1800.

Mr. JOSEPH DOWLEY,
Chief Counsel, Committee on Ways and Means, House of Representatives, Washington, DC.

DEAR SIR: This letter is submitted for the record of written comments on H.R. 1800, the Technical Corrections Act of 1985.

Section 555 of the Tax Reform Act of 1984 (the "1984 Act") changed the method of determining the fair market value of stock subject to an incentive stock option ("ISO") for purposes both of determining the exercise price of the ISO and of measuring the amount of the tax preference item (under Section 57(a)(10) of the Internal Revenue Code) when the ISO is exercised. The effective date provisions for these amendments are the subject of Section 155 of H.R. 1800, the Technical Corrections Act of 1985, which would retroactively cause the tax preference provisions to apply to options which ISO holders could have reasonably believed to be "grandfathered" by the 1984 Act. I am writing to urge that this change not be made, or, if made, that it allow holders of these ISOs some margin of time to exercise their options under the old rules.

Section 422A(c)(10) of the Code was added by the 1984 Act to provide that the fair market value of a share of ISO stock shall be determined without regard to any restrictions other than those that by their terms will never lapse ("non-lapse" restrictions). Section 57(a)(10) was amended by the 1984 Act to provide that for the purposes of the alternative minimum tax, the fair market value of a share of ISO stock on exercise of the underlying option is determined without regard to any restrictions other than non-lapse restrictions. In addition, Section 425(h)(3) of the Code was amended by the 1984 Act to provide that the modification of an option to make it non-transferable creates a new option.

The above three changes to the ISO rules are contained in, respectively, Sections 555(a)(1), 555(a)(2), and 555(b) of the 1984 Act, as follows:

(a) DETERMINATION OF FAIR MARKET VALUE.—

(1) IN GENERAL.—Subsection (c) of section 422A (relating to special rules) is amended by adding at the end there of [sic] the following new paragraph:

"(10) FAIR MARKET VALUE.—For purposes of this section, the fair market value of stock shall be determined without regard to any restriction other than a restriction which, by its terms, will never lapse.".

(2) INCENTIVE STOCK OPTION AS AN ITEM OF TAX PREFERENCE.—Paragraph (10) of section 57(a) (relating to items of tax preference) is amended by adding at the end thereof the following new sentence: "For purposes of this paragraph, the fair market value of a share of stock shall be determined without regard to any restriction other than a restriction which, by its terms, will never lapse."

The effective date provision covering subsection (2) above, and thus governing the new method of determining fair market value both under the ISO rules themselves and under the tax preference rules, is set forth in Section 555(c)(1) of the 1984 Act, which unequivocally makes the new two provisions of subsection (a) inapplicable to options granted on or before March 20, 1984:

(c) EFFECTIVE DATES.—

(1) FAIR MARKET VALUE.—The amendment made by subsection (a) shall apply to options granted after March 20, 1984, except that such subsection shall not

apply to any incentive stock option granted before September 20, 1984, pursuant to a plan adopted or corporate action taken by the board of directors of the grantor corporation before May 15, 1984.

As described below, Section 155 of the Technical Corrections Act would change this effective date as to the measurement of the ISO tax preference item to "grandfather" ISOs granted before March 20, 1984, only if they were exercised before January 1, 1985.

The reason that a change is now sought in this effective date provision is apparently contained in Section 555(c)(2) and (c)(3) of the 1984 Act, which provides as follows:

> (2) ITEMS OF TAX PREFERENCE.—The amendment made by subsection (b) shall apply to options exercised after March 20, 1984. In the case of an option issued after March 20, 1984, pursuant to a plan adopted or corporate action taken by the board of directors of the grantor corporation before May 15, 1984, the preceding sentence shall be applied by substituting "December 31, 1984" for "March 20, 1984."
>
> (3) MODIFICATIONS.—The amendment made by subsection (c) shall apply with respect to modifications of options after March 20, 1984.

These two effective date provisions clearly present some difficulties of interpretation. By its terms, subparagraph (3) applies to the effective date provisions themselves, in subsection (c), even though the caption suggests that it was intended to apply to the modification provisions of subsection (b). Subparagraph (2) by its terms applies to the modification provisions of subsection (b) and also states a rule which is both convoluted and, when deciphered, unfair, in that it treats options granted after the new rules had been announced more favorably than those which were already in place.

Section 155 of the Technical Corrections Act would attempt to resolve these difficulties by (1) changing the effective date in Section 555(c)(1) of the 1984 Act to apply only to the ISO pricing provisions set forth in Section 555(a)(1) of the 1984 Act, (2) changing the effective date provisions of Section 555(c)(2) of the 1984 Act to cover the tax preference rule contained in Section 555(a)(2) of the 1984 Act, and (3) changing the effective date provision in Section 555(a)(3) of the 1984 Act to apply to the modification rule in Section 555(b) of the 1984 Act. As to the tax preference provisions, the Joint Committee on Taxation's "Description of the Technical Corrections Act of 1985" (H.R. 1800 and S. 814) (JCS–7–85), Apr. 14, 1985, at p. 110, states that the change merely "clarifies" the 1984 Act.

For several reasons, the change that would be made in the effective date of the new tax preference rules is markedly unfair to taxpayers holding options granted on or before March 20, 1984.

First, as a matter of substantive law, taxpayers have been entitled to rely upon the clear and unambiguous language of Section 555(c)(1) of the 1984 Act, which "grandfathered" options granted on or before March 20, 1984 for both ISO and tax preference purposes. The Joint Committee Staff explanation that the proposed technical amendment merely "clarifies" the 1984 Act must be based principally upon the subheading of Section 555(c)(2) of the Act. However, the heading of Section 555(c)(1), "Fair Market Value" unambiguously refers to both the ISO rule change in Section 555(a)(1) and the tax preference change in Section 555(a)(2), both of which announce new rules for determining fair market value in those contexts, and it is an established rule of statutory construction in any event that although section and paragraph headings can be used to glean the intent of ambiguous provisions, they cannot be used to limit or negate plain meanings. *Farr* v. *Commissioner,* 33 B.T.A. 557, 564 (1935). Since Section 555(c)(1) is unambiguous on its face, under this rule any ambiguity arguably contained in Section 555(c)(2) would have no effect on it.

Second, the reasonableness of a taxpayer relying on this rule of construction is demonstrated by the fact that both of the major tax publishing houses, Prentice-Hall, Inc., and Commerce Clearing House, Inc., state in the booklets that each released as to the 1984 Act and in their current federal tax services, that the tax preference changes do not apply to options granted on or before March 20, 1984. Commerce Clearing House, Inc., "Tax Reform Act of 1984, Law and Controlling Committee Reports," p. 123 (1984); Prentice-Hall, Inc., "A Complete Guide to the Tax Reform Act of 1984," p. 705 (1984); Commerce Clearing House, Inc., "Standard Federal Tax Reporter," Internal Revenue Code Vol. I, p. 4019–4 (1985); Prentice-Hall, Inc., "P-H Federal Taxes 1985," Vol. 2, p. 6086 (1985). Copies of the foregoing pages, with the cited language marked, are attached hereto for ease of reference. It is thus clear that taxpayers' reliance upon the clear language of Section 555(c)(1) of the 1984 Act has been reasonable.

Third, before publication of the Joint Committee's "General Explanation of the Deficit Reduction Act of 1985" on December 31, 1984, there was no clear expression of Congressional intent contrary to the plain language of Section 555(c)(1). Both the Senate Finance Committee Report, S.Prt. No. 98-169, 98th Cong., 2d Sess. 767 (1984) and the Conference Report, H.R. Rep. No. 98-861, 98th Cong., 2d Sess. 1178 (1984), state only that the ISO amendments are to be effective for "options granted, exercised, or modified (as the case may be) after March 20, 1984."

Next, as a commonsense matter, a taxpayer reading Section 555(c)(1) and 555(c)(2) together would probably conclude, particularly in light of the rule of statutory construction described above, that the principal drafting error was that Section 555(c)(2) was not dropped from the 1984 Act altogether. From the subsection reference in Section 555(c), it seems a fair inference that at some point in the initial drafting process (most likely before the first appearance of these provisions in Section 827 of S. 2062), Section 555 was divided into four subsections, (a) through (d), subsection (a) stating the amendment that finally appeared in Section 555(a)(1) and subsection (b) containing the tax preference amendment. It is also a fair inference, however, that the intent of the draftsman was then to combine the two fair market value rules, which in terms of subject matter belong together, into a single subsection subject to a single effective date. This conclusion also explains the garbled nature of Section 555(c)(2), on the ground that not much attention was paid to it since it was to be deleted in any event.

Finally, the amendment proposed by Section 155 appears inappropriate and unfair as it applies to the ISO tax preference provisions, in that it would again treat holders of options granted after the March 20, 1984 threshold date more favorably than taxpayers holding ISOs granted on or before that date. Taxpayers with qualifying post-March 20, 1984 ISOs at least had the benefit of knowing that there was a definite cut-off date—December 31, 1984—by which they had to exercise or become subject to the new tax preference rules. Holders of pre-March 20, 1984 ISOs, however, had no definite warning of a cut-off date until the publication of the Joint Committee's *"General Explanation"* on December 31, 1984, followed by the introduction of H.R. 1800 and S. 814, which informed such taxpayers that (a) there is such a cut-off date and (b) that it has already passed.

For all of the reasons summarized above, I submit that fairness to taxpayers holding ISOs granted before March 20, 1984, dictates that they should receive a definite advance warning that they have only a limited period in which to exercise those options without becoming subject to the new ISO rules. At a minimum, I would propose that these taxpayers therefore be allowed some reasonable time—e.g., three to six months—after enactment of the Technical Correction Act to make these exercises.

I appreciate your thoughtful consideration of this matter. Please contact me if additional discussion of any of the points raised above would be helpful.

Very truly yours,

GLENN A. SMITH.

Act Sec. 111(e)(6) amended Code Sec. 57(a)(12)(B) to read as above. Prior to amendment, it read as follows:

(B) 15-Year Real Property.—With respect to each recovery property which is 15-year real property, the amount (if any) by which the deduction allowed under section 168(a) for the taxable year exceeds the deduction which would have been allowable for the taxable year had the property been depreciated using a 15-year period and the straight-line method (without regard to salvage value).

Act Sec. 111(e)(7) amended Code Sec. 57(a)(12)(E) by striking out " '15-year real property' " and inserting in lieu thereof " '18-year real property', 'low-income housing',".

The above amendments apply, generally, with respect to property placed in service by the taxpayer after March 15, 1984. For special rules, see Act Sec. 111(g)(2)-(4) following Code Sec. 168.

Act Sec. 555(a)(2) amended Code Sec. 57(a)(10) by adding the sentence at the end thereof.

The above amendment applies to options granted after March 20, 1984, except that such subsection shall not apply to any incentive stock option granted before September 20, 1984, pursuant to a plan adopted or corporate action taken by the board of directors of the grantor corporation before May 15, 1984.

Act Sec. 711(a)(3)(A) amended Code Sec. 57(a)(6)(B) to read as above. Prior to amendment, Code Sec. 57(a)(6)(B) read as follows:

(B) the amount which would have been allowable for the taxable year if the circulation expenditures described in section 173 or the research and experimental expenditures described in section 174 had been capitalized and amortized ratably over the 10-year period beginning with the taxable year in which such expenditures were made.

The above amendment takes effect as if included in the provision of the Tax Equity and Fiscal Responsibility Act of 1982 to which such amendment relates.

Act Sec. 722(a)(1)(A)-(B) amended Code Sec. 57(a)(12) by striking out "(or, in the case of property described in section 167(k), under section 167)" in subparagraph (A), and inserting "(or, in the case of property described in section 167(k), under section 167)" after "section 168(a)" in subparagraph (B) (as amended by Act Sec. 111(e)(6)).

The above amendment shall take effect as if included in the provisions of the Technical Corrections Act of 1982 to which such amendment relates.

[¶ 1038] CODE SEC. 58. RULES FOR APPLICATION OF THIS PART.

* * *

(i) OPTIONAL 10-YEAR WRITEOFF OF CERTAIN TAX PREFERENCES.—

(1) In General.—For purposes of this title, in the case of an individual, any qualified expenditure to which an election under this paragraph applies shall be allowed as a deduction ratably over the *10-year period (3-year period in the case of circulation expenditures described in section 173)* beginning with the taxable year in which such expenditure was made.

* * *

(4) Special Election for Intangible Drilling and Development Costs Not Allocable to Limited Business Interest.—

(A) In General.—In the case of any nonlimited partnership intangible drilling costs *(with respect to wells located in the United States)* to which an election under this paragraph applies—

* * *

Amendment Notes

Act Sec. 711(a)(2) amended Code Sec. 58(i)(4)(A) by inserting "(with respect to wells located in the United States)" after "intangible drilling costs".

Act Sec. 711(a)(3)(B) amended Code Sec. 58(i)(1) by striking out "10-year period" and inserting in lieu thereof "10-year period (3-year period in the case of circulation expenditures described in section 173)".

The above amendments shall take effect as if included in the provisions of the Tax Equity and Fiscal Responsibility Act of 1982 to which such amendments relate.

[¶ 1039] CODE SEC. 61. GROSS INCOME DEFINED.

(a) GENERAL DEFINITION.—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, *commissions, fringe benefits, and similar items;*

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[For official explanation, see Committee Reports, ¶2700.1]

[¶1689] CODE SEC. 57. ITEMS OF TAX PREFERENCE.

(a) In General.—For purposes of this part, the items of tax preference are—

(1) Exclusion of [1] dividends.—Any amount excluded from gross income for the taxable year under section 116 [2]

* * * * * * * * * * * * *

(6) Circulation and research and experimental expenditures.—An amount equal to the excess of—

(A) the amount allowable as a deduction under section 173 or 174(a) for the taxable year, over

(B) the amount which would have been allowable for the taxable year *with respect to expenditures paid or incurred during such taxable year* if—

(i) the circulation expenditures described in section 173 [3] *had been capitalized and amortized ratably over the 3-year period beginning with the taxable year in which such expenditures were made, or*

(ii) the research and experimental expenditures described in section 174 had been capitalized and amortized ratably over the 10-year period beginning with the taxable year in which such expenditures were made.

* * * * * * * * * * * * *

(10) Incentive stock options.—With respect to the transfer of a share of stock pursuant to the exercise of an incentive stock option (as defined in section 422A), the amount by which the fair market value of the share at the time of exercise exceeds the option price. *For purposes of this paragraph, the fair market value of a share of stock shall be determined without regard to any restriction other than a restriction which, by its terms, will never lapse.*

* * * * * * * * * * * * *

(12) Accelerated cost recovery deduction.—

(A) In general.—With respect to each recovery property (other than *18-year real property and low-income housing)* which is subject to a lease, the amount (if any) by which the deduction allowed under section 168(a),[4] for the taxable year exceeds the deduction which would have been allowable for the taxable year had the property been depreciated using the straight-line method (with a half-year convention and without regard to salvage value) and a recovery period determined in accordance with the following table:

[Footnote ¶1689] Section 16(b), '84 TRA struck out from Sec. 57(a)(1):

(1) **"interest and"**

(2) "or 128"

Effective date (Sec. 18(a), '84 TRA).—Applies to taxable years ending after 12-31-83.

Matter in *italics* in Sec. 57(a)(6)(B) added by section 711(a)(3)(A), '84 TRA, which struck out:

(3) "or"

Effective date (Sec. 715, '84 TRA and section 201(e)(1), '82 TEFRA).—Applies to taxable years beginning after 12-31-82.

The last sentence in *italics* in sec. 57(a)(10) added by section 555(a)(2), '84 TRA.

Effective date (Sec. 555(c)(1), '84 TRA).—Applies to options granted after 3-20-84, except that such subsection shall not apply to any incentive stock option granted before 9-20-84, pursuant to a plan adopted or corporate action taken by the board of directors of the grantor corporation before 5-15-84.

Section 111(e)(5), '84 TRA amended Sec. 57(a)(12)(A) by striking out "15-year real property" and inserting in lieu thereof "18-year real property and low-income housing".

Effective date (Sec. 111(g), '84 TRA).—Generally applies with respect to property placed in service by the taxpayer after 3-15-84. For exceptions and special rules, see footnote [4] 1725.

Section 722(a)(1)(A), '84 TRA struck out from Sec. 57(a)(12):

(4) "(or, in the case of property described in section 167(k), under section 167)"

Effective date (Sec. 722(a)(6), '84 TRA, Sec. 109, '82 TCA and 209(a), '81 ERTA).—Applies generally to property placed in service after 12-31-80, in taxable years ending after such date.

Matter in *italics* in Sec. 57(a)(12)(B) added by section 111(e)(6), '84 TRA, which struck out:

section 167(k), under section 167) for the taxble year exceeds the deduction which would have been allowable for the taxable year had the property been depreciated using a 15-year period and the straight-line method (without regard to salvage value).

Act Sec. 111(e)(7) amended Code Sec. 57(a)(12)(E) by striking out "'15-year real property'" and inserting in lieu thereof "'18-year real property', 'low-income housing',".

The above amendments apply, generally, with respect to property placed in service by the taxpayer after March 15, 1984. For special rules, see Act Sec. 111(g)(2)-(4) following Code Sec. 168(b).

P.L. 98-369, § 555(a)(2):

Act Sec. 555(a)(2) amended Code Sec. 57(a)(10) by adding the sentence at the end thereof.

The above amendment applies to options granted after March 20, 1984. In the case of an option issued after March 20, 1984, pursuant to a plan adopted or corporate action taken by the board of directors of the grantor corporation before May 15, 1984, the preceding sentence shall be applied by substituting "December 31, 1984" for "March 20, 1984".

P.L. 98-369, § 711(a)(3)(A):

Act Sec. 711(a)(3)(A) amended Code Sec. 57(a)(6)(B) to read as above. Prior to amendment, Code Sec. 57(a)(6)(B) read as follows:

(B) the amount which would have been allowable for the taxable year if the circulation expenditures described in section 173 or the research and experimental expenditures described in section 174 had been capitalized and amortized ratably over the 10-year period beginining with the taxable year in which such expenditures were made.

The above amendment takes effect as if included in the provision of the Tax Equity and Fiscal Responsibility Act of 1982 to which such amendment relates.

P.L. 98-369, § 722(a)(1)(A)-(B):

Act Sec. 722(a)(1)(A)-(B) amended Code Sec. 57(a)(12) by striking out "(or, in the case of property described in section 167(k), under section 167)" in subparagraph (A), and inserting "(or, in the case of property described in section 167(k), under section 167)" after "section 168(a)" in subparagraph (B) [as amended by Act Sec. 111(e)(6)]. [A technical correction apparently will be needed to rectify the unintentional omission.—CCH.]

The above amendment takes effect as if included in the provisions of the Technical Corrections Act of 1982 to which such amendment relates.

P.L. 97-448, § 102(b)(1)(A):

Amended the next to the last sentence of Code Sec. 57(a) by striking out "and (12)" and inserting in lieu thereof "and (12)(A)", effective as if included in the amendment made by P.L. 97-34, § 205(b), but not applicable to tax years beginning after December 31, 1982.

P.L. 97-448, § 102(b)(3):

Amended Code Sec. 57(a)(12) by redesignating subparagraphs (C) and (D) as subparagraphs (D) and (E), respectively, and by inserting after subparagraph (B) the new subparagraph (C) above, effective as if such amendment had been included in the provision of P.L. 97-34 to which it relates.

P.L. 97-448, § 102(b)(4):

Amended Code Sec. 57(a)(12)(A) by striking out "under section 168(a)" and inserting in lieu thereof "under section 168(a) (or, in the case of property described in section 167(k), under section 167)", effective as if such amendment had been included in the provision of P.L. 97-34 to which it relates.

P.L. 97-448, § 102(f)(1):

Amended subparagraph (B) of section 212(e)(2) of P.L. 97-34 to read as below under the amendment note for P.L. 97-34, § 212(e)(2).

P.L. 97-354, § 5(a)(14):

Amended the last sentence of Code Sec. 57(a) by striking out "an electing small business corporation (as defined in section 1371(b)) and".

Applicable to tax years beginning after December 31, 1982.

P.L. 97-248, § 201(b)(1)(A):

Amended Code Sec. 57(a) by striking out paragraph (1) and inserting in lieu thereof new paragraph (1) above. Prior to amendment, Code Sec. 57(a)(1) read as follows:

"(1) **Adjusted itemized deductions.**—In the case of an individual, an amount equal to the adjusted itemized deductions for the taxable year (as determined under subsection (b))." Applicable to tax years beginning after December 31, 1982.

P.L. 97-248, § 201(b)(1)(B):

Amended Code Sec. 57(a) by striking out paragraphs (5) and (6) and inserting in lieu thereof new paragraphs (5) and (6) above. Prior to amendment, Code Sec. 57(a)(5) and (6) read as follows:

"(5) **Amortization of railroad rolling stock.**—With respect to each unit of railroad rolling stock for which an election is in effect under section 184, the amount by which the deduction allowable for the taxable year under such section exceeds the depreciation deduction which would otherwise be allowable under section 167.

(6) **Stock options.**—With respect to the transfer of a share of stock pursuant to the exercise of a qualified stock option (as defined in section 422(b)) or a restricted stock option (as defined in section 424(b)), the amount by which the fair market value of the share at the time of exercise exceeds the option price." Applicable to tax years beginning after December 31, 1982.

P.L. 97-248, § 201(b)(1)(C):

Amended Code Sec. 57(a) by striking out paragraph (10) and inserting in lieu thereof new paragraph (10) to read as above. Prior to amendment, paragraph (10) read as follows:

"(10) **Amortization of child care facilities.**—With respect to each item of section 188 property for which an election is in effect under section 188, the amount by which the deduction allowable for the taxable year under such section exceeds the depreciation deduction which would otherwise be allowable under section 167." Applicable to tax years beginning after December 31, 1982.

P.L. 97-248, § 201(b)(2)(A):

Amended the next to last sentence of Code Sec. 57(a) by striking out "(3), (11), and (12)" and inserting in lieu thereof "(1), (3), (5), (6), (11), and (12)(A)". Applicable to tax years beginning after December 31, 1982.

P.L. 97-248, § 201(b)(2)(B):

Amended Code Sec. 57(a) by striking out the last sentence. Prior to amendment, the last sentence read as follows:

"For purposes of section 56, in the case of a taxpayer other than a corporation, the adjusted itemized deductions described in paragraph (1) and capital gains described in paragraph (9) shall not be treated as items of tax preference." Applicable to tax years beginning after December 31, 1982.

P.L. 97-34, § 205(a):

Amended Code Sec. 57(a) by inserting immediately after paragraph (11) new paragraph (12). Applicable to property placed in service after December 31, 1980, in taxable years ending after such date.

P.L. 97-34, § 205(b):

Amended Code Sec. 57(a) by striking out "and (11)" in the next to the last sentence and inserting in lieu thereof ", (11), and (12)(A)". Applicable to property placed in service after December 31, 1980, in taxable years ending after such date.

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6086 Minimum Tax on Tax Preferences [5]

LAW [¶6135] **CODE SEC. 57. ITEMS OF TAX PREFERENCE.**

(a) **In General.**—For purposes of this part, the items of tax preference are—

(1) **Exclusion of [1] dividends.**—Any amount excluded from gross income for the taxable year under section 116 [2]

(2) **Accelerated depreciation on real property.**—With respect to each section 1250 property (as defined in section 1250(c)), the amount by which the deduction allowable for the taxable year for exhaustion, wear and tear, obsolescence, or amortization exceeds the depreciation deduction which would have been allowable for the taxable year had the taxpayer depreciated the property under the straight line method for each taxable year of its useful life (determined without regard to section 167(k) for which the taxpayer has held the property.

(3) **Accelerated depreciation on leased personal property.**—With respect to each item of section 1245 property (as defined in section 1245(a)(3)) which is subject to a lease, the amount by which—

(A) the deduction allowable for the taxable year for depreciation or amortization, exceeds

(B) the deduction which would have been allowable for the taxable year had the taxpayer depreciated the property under the straight line method for each taxable year of its useful life for which the taxpayer has held the property.

For purposes of subparagraph (B), useful life shall be determined as if section 167(m)(1) (relating to asset depreciation range) did not include the last sentence thereof.

(4) **Amortization of certified pollution control facilities.**—With respect to each certified pollution control facility for which an election is in effect under section 169, the amount by which the deduction allowable for the taxable year under such section exceeds the depreciation deduction which would otherwise be allowable under section 167.

(5) **Mining exploration and development costs.**—With respect to each mine or other natural deposit (other than an oil or gas well) of the taxpayer, an amount equal to the excess of—

(A) the amount allowable as a deduction under section 616(a) or 617, over

(B) the amount which would have been allowable if the expenditures had been capitalized and amortized ratably over the 10-year period beginning with the taxable year in which such expenditures were made.

(6) **Circulation and research and experimental expenditures.**—An amount equal to the excess of—

(A) the amount allowable as a deduction under section 173 or 174(a) for the taxable year, over

(B) the amount which would have been allowable for the taxable year *with respect to expenditures paid or incurred during such taxable year* if—

(i) the circulation expenditures described in section 173 [3] *had been capitalized and amortized ratably over the 3-year period beginning with the taxable year in which such expenditures were made, or*

[Footnote ¶6135] Section 16(b), '84 TRA struck out from Sec. 57(a)(1):

(1) "interest and"

(2) "or 128"

Effective date (Sec. 19(a), '84 TRA).—Applies to taxable years ending after 12-31-83.

Matter in *italics* in Sec. 57(a)(6)(B) added by section 711(a)(3)(A), '84 TRA, which struck out:

(3) "or"

Effective date (Sec. 715, '84 TRA and section 201(e)(1), '82 TEFRA).—Applies to taxable years beginning after 12-31-82.

The last sentence in *italics* in sec. 57(a)(10) added by section 555(a)(2), '84 TRA.

Effective date (Sec. 555(c)(1), '84 TRA).—Applies to options granted after 3-20-84, except that such subsection shall not apply to any incentive stock option granted before 9-20-84, pursuant to a plan adopted or corporate action taken by the board of directors of the grantor corporation before 5-15-84.

Section 111(e)(5), '84 TRA amended Sec. 57(a)(12)(A) by striking out "15-year real property" and inserting in lieu thereof "18-year real property and low-income housing".

Effective date (Sec. 111(g), '84 TRA).—Generally applies with respect to property placed in service by the taxpayer after 3-15-84. For exceptions and special rules, see footnote ¶15,602 or Amending Acts, Code Volume II.

HELLER, EHRMAN, WHITE & MCAULIFFE,
San Francisco, CA, May 28, 1985.

Re Proposed amendment to effective date of Internal Revenue Code section 312(n)(8) contained in section 104(e)(3) of H.R. 1800.

Mr. JOSEPH DOWLEY,
Chief Counsel, Committee on Ways and Means, House of Representatives, Washington, DC.

DEAR SIR: This letter is submitted for the record of written comments on H.R. 1800, the Technical Corrections Act of 1985.

Section 61(a) of the Tax Reform Act of 1984 (the "1984 Act") made several changes to the rules governing the computation of corporate earnings and profits as paragraphs (1) through (9) of Section 312(n) of the Internal Revenue Code. The effective date for Code Section 312(n)(8) was omitted from the 1984 Act. Section 104(e)(3) of H.R. 1800 would cause the new statute (re-numbered as Section 312(n)(7)) to apply to distributions after July 18, 1984. Examination of the legislative history of this provision clearly indicates, however, that Section 312(n)(8) should be effective only for distributions in taxable years beginning after September 30, 1984, and I am writing to urge that the Technical Corrections Act be amended to state that effective date.

Code Section 312(n)(8) reverses the rule of *Jarvis* v. *Commissioner*, 43 B.T.A. 439 (1949), acq. Rev. Rul. 79-376, 1979-2 C.B. 133. Under *Jarvis* and Rev. Rul. 79-376, when a corporation redeemed a portion of its stock, the concomitant earnings and profits reduction was computed as the excess of the amount of the redemption over the portion of the corporation's historic (cost basis) capital account allocable to the redeemed shares. Under the new rule of Section 312(n)(8), the reduction in earnings and profits is proportional to the percentage of stock redeemed, generally resulting in a much smaller reduction of earnings and profits.

All of the 1984 Act's changes to the computation of corporate earnings and profits originated in Section 47 of the Senate bill, S. 2062. As proposed in Section 47(a)(1), the provisions in Code Section 312(n) were to be effective generally for "amounts paid or incurred in, or distributions or redemptions occurring in" taxable years beginning after the date of enactment. Specific exceptions to this general effective date covered new Code Sections 312(n)(4) (distributions of appreciated property), 312(n)(5) (LIFO adjustments), 312(n)(6) (installment sales), and 312(n)(7) (completed contract method of accounting). Under this formulation, the restrictive provisions of Code Section 312(n)(8) would not become effective until the taxpayer's first taxable year beginning after the date of enactment of the 1984 Act.

As finally adopted in Section 61 of the Conference report, the effective dates of the provisions contained in Code Section 312(n) were generally delayed until taxable years beginning after September 30, 1984. In form, the Conference report did not express Section 312(n)'s effective dates as a general rule with exceptions, as the Senate bill had, but instead expressed each effective date as a discrete provision matched with one or more paragraphs of Section 312(n). In the process of revising the structure of the effective date provisions, however, Section 312(n)(8) was overlooked. The Staff of the Joint Committee on Taxation, in the "General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984" (1984) ("General Explanation"), then took the position that Code Section 312(n)(8) is effective for distributions after July 18, 1984, the date of enactment of the 1984 Act (General Explanation, p. 181), and Section 104(e)(3) of the Technical Corrections Act now would confirm that effective date.

The effect of this change, however, is to unfairly burden taxpayers who reasonably relied upon the effective date contained in the Senate bill, since there was no reasonable notice of a different effective date in the Conference report. The Senate Finance Committee Report, S. Prt. No. 98-169, 98th Cong., 2d Sess. 202 (1984), in complete consonance with Section 47 of the Senate bill, stated that Code Section 312(n)(8) would be effective for "distributions in taxable years beginning after the date [of] enactment." The Conference Report, H.R. Rep. No. 98-861, 98th Cong., 2d Sess. 840 (1984), states that "[t]he conference agreement is generally the same as the Senate amendment" regarding the provisions of Section 312(n)(8) and mentions no change in effective date, although other clarifications are discussed in detail.

In this context, I submit that it must be presumed that it was mere drafting error that caused the omission from the 1984 Act of a provision making Section 312(n)(8) of the Code effective for taxable years beginning after September 30, 1984. In a sense, this is an issue that goes to the basic faith kept between the Congressional tax committees and taxpayers generally. For taxpayers to be able to plan transactions with some modicum of certainty, they need to be assured that the effective

date of a proposed new restriction, once announced, won't be made earlier, at least not without fair notice and a compelling reason to do so. In the case of the effective date of Code Section 312(n)(8), there was neither notice of an intended change, nor does any compelling reason suggest itself for distinguishing subsection (8) from the other subsections of Section 312(n) by cutting back on its effective date.

In consequence, I strongly urge that Section 104(e)(3) of H.R. 1800 be amended to provide that present Code Section 312(n)(8) (to become Section 312(n)(7) after redesignation by H.R. 1800) applies only to distributions occurring after September 30, 1984, in taxable years beginning after that date.

I appreciate your thoughtful consideration of this matter; please contact me if additional discussion of any of the points raised above would be helpful.

Very truly yours,

GLENN A. SMITH.

STATEMENT OF HOPKINS & SUTTER, CHICAGO, IL

Re H.R. 1800 (Technical Corrections Act of 1985)—technical correction of effective date associated with repeal of 30 percent withholding tax.

SUMMARY

Antilles financing subsidiaries were long used, with Treasury approval, as a means of borrowing in the Eurobond market, without incurring U.S. tax liabilities which would, if applicable, have rendered such borrowing impracticably expensive.

In the Tax Reform Act of 1984 (the "Act"), the tax-free result was made directly available (i.e., without need for a financing subsidiary) after July 18, 1984, and the use of Antilles subsidiaries was specifically approved for issuances before June 22, 1984. That left a 26-day "gap" period between June 22 and July 18, during which issuances are not explicitly covered by statute. The gap period is inconsistent with the underlying policy of facilitating Eurobond borrowing, and creates possible uncertainties for issues which were committed before June 22, but issued during the 26-day gap. It is requested that the gap be eliminated for such issuances by extending the grandfather provision for pre-June 22 issuances to cover issuances prior to July 18 that were committed to before June 22, 1984.

BACKGROUND

Prior to the Act, interest paid on obligations issued by United States corporations to nonresident aliens and foreign corporations was generally subject to the 30% withholding tax imposed by Sections 1441 and 1442 of the Internal Revenue Code of 1954, as amended (the "Code"). Because this tax was generally unacceptable to foreign investors (and because the absorption of the tax by the issuers through the "grossing-up" of the interest payments would make the expense of borrowing prohibitively costly and noncompetitive), U.S. corporations could not issue their obligations directly in the "Eurobond market" (the network of underwriters and financial institutions who market corporate bonds outside the United States). Accordingly, in order to avail themselves of this important source of financing, U.S. corporations would organize financing subsidiaries in the Netherlands Antilles. The financing subsidiaries would issue obligations in the Eurobond market and then loan the proceeds back to the United States parent. The concept was that interest paid both by the Antilles subsidiary to its bondholders and by the domestic parent to the Antilles subsidiary would be exempt from the 30% withholding tax under applicable provisions of the Antilles-U.S. bilateral tax convention.

The use of Netherlands Antilles financing subsidiaries commenced during the Johnson administration in the late 1960s and quickly came to be a standard technique by which U.S. companies borrowed abroad. A central international economic problem in that era was the maintenance of fixed exchange rates, and in order to maintain the dollar exchange rate the interest equalization tax then in effect was designed to discourage U.S. persons from lending abroad. It was desirable to permit them to borrow abroad, but if they did so, the interest equalization tax prevented them from relenting the proceeds abroad—an unintended and undesirable result. In order to avoid that result, the Treasury Department, under Assistant Secretary Surrey, specifically approved the use of Antilles financing subsidiaries in a series of published rulings and the IRS issued numerous private rulings approving such arrangements and recognizing the independent existence of the Antilles financing companies. However, in 1974, following the abandonment of fixed exchange rates and the expiration of the interest equalization tax, the Service announced that it

would no longer rule with respect to such subsidiaries (but did not revoke existing rulings). Despite this announcement and a lack of clear precedent, U.S. corporations, desiring to raise funds in the Eurobond market, continued to use Netherlands Antilles subsidiaries to issue Eurobond obligations. By the early 1980s, hundreds of millions of dollars of obligations had not been issued in this manner. During this latter period, the Antilles arrangement was simply a convenient technique to gain easy access to the Eurobond capital market, which would have been effectively foreclosed to U.S. borrowers if a 30% withholding tax were imposed.[1]

The growing use of the Netherlands Antilles financing subsidiaries caused increasing scrutiny of these arrangements by the Internal Revenue Service, and the exemption from tax of interest paid on the subsidiaries' obligations began to be challenged by field agents on technical grounds inconsistent with the original IRS rulings. As a result, U.S. corporations became concerned that an important source of financing—the Eurobond market—would no longer be available. In part in response to this concern, companion bills were introduced in the House of Representatives and Senate pursuant to which the 30% withholding tax would be repealed for certain interest paid on obligations issued directly to foreign investors.[2] Other legislative proposals were made and, ultimately, what has become known as the portfolio interest exemption to the 30% withholding tax was enacted as Section 127 of the Tax Reform Act of 1984. Under this exemption, U.S. corporations, under certain circumstances, may issue obligations directly in the Eurobond market without interest on such obligations being subject to the 30% withholding tax. The new exemption was to be effective for obligations issued after the date of enactment, which turned out to be July 18, 1984.

In enacting the portfolio interest exemption, Congress was aware of the fact that the new exemption would not resolve the questions which had been raised as to existing obligations issued in the Eurobond market through Netherlands Antilles subsidiaries. In an effort to resolve these questions without disrupting the Eurobond market, Congress included the following language in Section 127(g) of the Act:

> (3) SPECIAL RULE FOR CERTAIN UNITED STATES AFFILIATED OBLIGATIONS.—
>
> (A) IN GENERAL.—For purposes of the Internal Revenue Code of 1954, payments of interest on a United States affiliate obligation to an applicable CFC in existence on or before June 22, 1984, shall be treated as payments to a resident of the country in which the applicable CFC is incorporated.
>
> (B) EXCEPTION.—Subparagraph (A) shall not apply to any applicable CFC which did not meet requirements which are based on the principles set forth in Revenue Rulings 69-501, 69-377, 70-645, and 73-110.
>
> (C) DEFINITIONS.—
>
> (i) The term "applicable CFC" has the meaning given such term by Section 121(b)(2)(D) of this Act, except that such section shall be applied by substituting "the date of interest payment" for "March 31, 1984," in clause (i) thereof.
>
> (ii) The term "United States affiliated obligation" means an obligation described in section 121(b)(2)(F) of this Act which was issued before June 22, 1984.

The effect of this language was that interest paid on obligations issued before June 22, 1984, by Netherlands Antilles financing subsidiaries of United States corporations was generally to be treated as exempt from the 30% withholding tax.

The use of the June 22, 1984 date in the grandfather language of Section 127(g)(3) coupled with the July 18, 1984 effective date of the new portfolio interest exemption rules resulted in a "gap period" during which U.S. corporations could neither be assured that they would be protected from the 30% withholding tax if they used a Netherlands Antilles subsidiary nor take advantage of the new portfolio interest exemption rules to issue obligations directly. In theory, this gap period, given its brevity, posed little problem—a United States corporate issuer could simply remain out of the Eurobond market for that period. In fact, however, the gap period placed several issuers in the troublesome position of having to issue through the Antilles without the protection of the grandfather language.

The reason for the foregoing predicament involves the nature of a Eurobond offering, which normally takes three to four weeks to complete. Such an offering is generally commenced by a "launch" telex, which announces the transaction and imme-

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[1] A much more detailed history of the tax treatment of interest paid to foreign investors generally and the use of Netherlands Antilles subsidiaries in particular is set forth in a pamphlet prepared by the staff of the Joint Committee of Taxation entitled, "Tax Treatment of the Interest Paid to Foreign Investors" (JCS-23-84, April 28, 1984).

[2] H.R. 3025 and S. 1557.

diately following which the securities are traded on a when-issued basis and are quoted in the markets. A few days later, the actual underwriting agreements are executed and delivered. The closing at which the securities are actually issued takes place two or three weeks after the execution of such documents. In the case of several issuers, the initial steps of a Eurobond offering were taken in early June, 1984. At that time, there was considerable uncertainty as to what, if anything, Congress would do on pending tax legislation with respect to withholding on interest to foreign bondholders. It was not until June 22, 1984, that the compromise solution incorporated in Section 127 of the Act was agreed upon. By that time, certain of these issuers were irrevocably committed to issuing obligations in the Eurobond market through their Antilles subsidiaries. These transactions were necessarily closed after June 22, 1984.

The concern of those United States corporations which had issued obligations in the Eurobond market through their Antilles financing subsidiaries after June 22, 1984, was heightened last October when the Internal Revenue Service issued Rev. Rul. 84-153, 1984-42 I.R.B. 9, in which the Service ruled that obligations issued after June 22 through a Netherlands Antilles subsidiary would not be exempt from the 30% withholding tax. The issuance of this ruling caused considerable controversy. In response, the Treasury, on October 18, 1984, issued a news release in which it invited issuers of, or investors in, obligations "in process prior to June 22, 1984," who believed that they had a reasonable basis for relief from the ruling to "take advantage of existing procedures to request such relief promptly from the Internal Revenue Service." The type of relief referred to was that afforded by Section 7805(b) of the Code, which allows the Service the discretion to apply certain rulings on a prospective basis only.

Accepting the Service's invitation, several issuers did submit requests for relief under Section 7805(b). In submitting these requests, the issuers sought to assure that obligations issued in the gap period but pursuant to a binding commitment entered into on or before June 22, 1984, would be within the protection of the grandfather language of Section 127(g)(3). After several months, the Service did issue Section 7805(b) rulings, but such rulings only provided as follows:

Pursuant to the authority contained in Section 7805(b), the holding of Rev. Rul. 84-153 will not be retroactively applied to the obligations issued on , 1984, by .

THE PROBLEM

Gap period issuers face continued uncertainty because of the particular language used in the Section 7805(b) rulings. The rulings prevent the Internal Revenue Service from challenging obligations issued in the gap period on the basis of the explicit holding in Rev. Rul. 84-153, but the Service may argue that interest paid on such obligations is subject to the 30% withholding on other grounds. This concern has been heightened by the understanding that IRS field agents have been resisting applying the grandfather language of Section 127(g)(3) even where the obligations were actually issued prior to June 22, 1984. The specific fear is that, given any opportunity to distinguish a situation from that explicitly described in Section 127(g)(3), the field agents will attempt to impose a withholding tax liability on interest paid with respect to gap period obligations issued by Netherlands Antilles subsidiaries, even if such obligations are within the intent of the grandfather language.

REASON FOR REMEDYING PROBLEM

In the Act, Congress attempted to resolve the tax issues presented by Eurobond obligations in a definitive manner. For future issuances, it provided the portfolio interest exemption which enabled obligations to be issued directly by the U.S. corporation. For past issuances, which necessarily had to be accomplished through such vehicles as a Netherlands Antilles financing subsidiary, the grandfather language of Section 127(g)(3) was added. Given such intent and the fact that issuers could not have known until June 22, 1984, that the grandfather language would apply only to obligations issued before that date, there can be no reason not to afford the same protection to obligations which were issued subject to a binding commitment in effect on June 22.

PROPOSED TECHNICAL CORRECTION

To alleviate the foregoing problem, it is respectfully submitted that the Technical Corrections Bill include a provision amending Section 127(g)(3) of the Act to read as set forth in Exhibit A. As so amended, the protection afforded by Section 127(g)(3)

would apply to obligations issued pursuant to a binding commitment in effect on June 22, 1984, as well as to obligations actually issued before that date.

EXHIBIT A

(3) SPECIAL RULE FOR CERTAIN UNITED STATES AFFILIATE OBLIGATIONS.—

* * * * * * *

(C) DEFINITIONS.—

* * * * * * *

(ii) The term "United States affiliate obligation" means an obligation described in section 121(b)(2)(F) of this Act which was issued before June 22, 1984 or which was issued on or after June 22, 1984 to an applicable CFC in direct connection with obligations issued by such applicable CFC pursuant to a binding commitment in effect on June 22, 1984.

HOUSTON NATURAL GAS CORP.,
Houston, TX, May 7, 1985.

Mr. JOSEPH K. DOWLEY,
Chief Counsel, House Committee on Ways and Means, House of Representatives, Washington, DC.

DEAR MR. DOWLEY: This is a written statement for the printed record in support of Section 175(c) of the Technical Corrections Act of 1985 (H.R. 1800) concerning the treatment of sales within an affiliated group for purposes of Section 29 of the Internal Revenue Code of 1954 ("Code").

Section 29 of the Code (Section 44D before the Tax Reform Act of 1984) was enacted to encourage the production of natural gas from unconventional sources. It did so by providing a credit for production which in effect provided protection against significant decreases in the price of uncontrolled domestic oil, with which alternative fuels frequently compete. Thus, Congress provided an incentive in the nature of a credit to produce such natural gas. Furthermore, the credit provided producers with the choice between production incentive of the credit or an incentive price for such gas under Section 107 of the Natural Gas Policy Act.

In order to be sure the credit was only available for actual sales and to avoid transfers without substance among related parties ("churning") just to generate a credit, Congress inserted a "related party" rule. Unfortunately, the "related party" rule could be interpreted to prohibit the credit in cases where the gas is sold by a company's production subsidiary to its pipeline subsidiary which then resells the gas to an unrelated party. Not only would this deprive natural gas pipelines with production affiliates of the tax credit, but also create the anomalous possibility of a producer getting neither the incentive price nor the credit for unconventional gas. Both of these would be contrary to Congressional intent.

The technical revision included in Section 175(c) of the bill corrects this by allowing the credit so long as a corporation within an affiliated group sells the qualified fuels to an unrelated person. Since the credit is only available for the "first sale" and there must be an actual sale to an unrelated party, there is no violation of the purpose for the related party rule.

Therefore, on behalf of Houston Natural Gas Corporation, Houston, Texas, this letter is in support of the inclusion of the language of Section 175(c) in H.R. 1800.

Sincerely,

ROBERT J. HERMANN,
Vice President, Corporate Taxes.

STATEMENT OF JOHN B. HUFFAKER, PHILADELPHIA, PA

I am John B. Huffaker, an attorney with my principal office at 2000 Fidelity Building, Philadelphia, Pa. 19109. This statement is submitted on behalf of Cataract, Inc., a corporation with its principal office at Newtown, Bucks County, Pennsylvania.

Cataract is in the business of leasing its employees to public utilities. They are highly skilled engineers and technicians that will work on a particular job for a period of months and then move to another site. The founder of Cataract sold his approximately 70% interest in the company to a newly created ESOT on January 2,

1985. He received cash and a Note payable over five years. The Note carries interest in compliance with the Internal Revenue Code provisions.

The Company is in position to substantially reduce the cash demands posed by the Note if it can borrow the funds from a bank and prepay the Note. Or stated differently, the stock in the ESOT will be released to the accounts of the participants more rapidly as the interest component of the payments it makes are reduced. Of course, the saving would reflect the lowering of interest rates in the last six months, the spreading of the payment over a longer period and the partially tax exempt character of the interest if received by a bank. While the existing Note is a Securities Acquisition Loan in the hands of the seller, the special interest provision only applies when the holder is a bank or other financial institution described in Section 133(a).

We believe that a loan for the purpose of retiring a stock purchase obligation (wholly or partially) meets the requirements of present law. Quite literally, the loan proceeds will be used to pay for the stock or, in the terms of the statute, "to acquire employer securities," and that would seem to be a "Securities Acquisition Loan." However, a question has been raised because the ESOT already has the stock—it's an obligation to the seller of the stock that is disposed of and it could be argued that the stock was "acquired" for the Note.

In such cases, it is not necessary to deny the ESOT the access to favorable financing under Sec. 133. It should not be significant whether the loan precedes or follows the sale as long as the use of the proceeds is clear. It is suggested that Sec. 133 be clarified by striking the "," at the end of Sec. 133(b)(1) and adding the following: "including the use of the proceeds to pay a purchase-money obligation incurred to the transferor of the employer securities."

This clarification will simplify the negotiation of purchases by ESOTs without offering an opportunity for successive refinancings.

Statement of Cecil A. Ray, Jr., Hughes & Luce, Dallas, TX

I. OVERVIEW

Prior to enactment of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), benefits under qualified employee plans were essentially excluded from the federal estate and gift tax system. Section 2039(c) of the Code excluded the value of qualified plan benefits from the gross estate of deceased employees. Moreover, neither the selection by an employee of the form of benefits to be paid to him, nor the designation of a beneficiary to receive payments after his death, was a transfer for gift tax purposes, I.R.C. § 2517.

Qualified plan benefits were also protected from adverse federal transfer tax consequences that could have resulted under community property laws. Plan benefits are generally community propert owned equally by the employee and a non-employee spouse. Most plans, however, are written as if the employee was entitled to receive and control all benefits. No benefits are payable as a result of the death of a non-employee spouse, nor does the spouse generally have any effective ability to designate a beneficiary for her interest in the plan. The federal estate and gift tax system reflected these realities in two ways. First, section 2039(d) provided that plan values attributable to community property laws would not be included in the estate of a non-employee spouse who predeceased the employee. Second, under section 2517(c), the non-employee spouse would not be considered to have made a taxable tranfer when benefits under the plan were transferred.

TEFRA capped the value of qualified plan benefits excludable from the gross estate of the employee at $100,000. TEFRA § 245(a). Section 525(a) of the Deficit Reduction Act of 1984 eliminated the employee's estate tax exclusion entirely, repealing section 2039(c) of the Code for decedents dying after 1984. The repeal did not apply, however, to a decedent who irrevocably elected the form of benefit before July 18, 1984, and who was "in pay status" on December 31, 1984. Deficit Reduction Act § 525(b)(2). Furthermore, the $100,000 cap enacted in TEFRA was made inapplicable to participants who had irrevocably elected the form of benefit before 1983 and were "in pay status" on December 31, 1982. Deficit Reduction Act § 525(b)(3). This provision had the effect of restoring the full pre-TEFRA estate tax exclusion to certain plan participants. I propose that section 525(b) of the Deficit Reduction Act be technically corrected to clearly extend the effective date relief to all participants who had irrevocably elected the form of benefit and had severed employment, regardless of whether under the specific form of benefit elected payments had already commenced.

Section 152(e) of the proposed Technical Corrections Act of 1985, H.R. 1800, repeals the exclusion of the community property interest in plan benefits from the estate of the non-working spouse and repeals the gift tax exclusion for transfers of plan benefits. For the reasons given below, this proposal should be deleted from the technical corrections bill. The final section of this statement suggests technical corrections to the Retirement Equity Act of 1984 ("REA") dealing with the interests of non-employee spouses.

II. PROPOSED AMENDMENT TO EFFECTIVE DATE RULES

The effective date exception in section 525(b) of the Deficit Reduction Act applies to plan participants who (1) had irrevocably elected the form of their benefits, and (2) were "in pay status." The meaning of the phrase "in pay status" is not transparent, nor is that phrase used generally in the Code. The Committee Reports do not provide any explanation of the Congressional intent underlying the effective date exception. The logical presumption is that Congress did not wish to be unfair to retirees who had elected a form of benefit in reliance on the estate tax exclusion and who could not now change that election. Unfortunately, the words of the statute imperfectly reflect this intention. The requirement that a participant be "in pay status" may be read to mean that actual payments must have begun, thus excluding retirees who had irrevocably elected a form of benefit under which payments do not begin until a more advanced age.

A technical correction to section 525(b) is warranted. The correction should extend the effective date exception to participants who before the applicable dates had (1) irrevocably elected the form of their benefits, and (2) terminated employment. This simple change would prevent clearly inequitable treatment of an unknown number of unsuspecting retirees. Suppose Mr. A and Mr. B both turned 65 and retired in 1981. Mr. A irrevocably elected to receive monthly payments from the company pension or profit-sharing plan commencing immediately. Mr. B believed he had sufficient assets to make ends meet for a few years and was particularly concerned about having sufficient income to meet the expenses of an extended old age. Mr. B therefore irrevocably elected to allow plan values to continue to build and not to begin receiving benefits until age 70½. (The irrevocable election was required to avoid constructive receipt under section 402(a)(1) before its amendment in 1981.) Mr. B realized that this choice would increase the expected value of plan benefits at his death, but he relied on section 2039(c) to exclude those increased benefits from the estate tax. The legislative process, however, has now played a cruel joke on Mr. B. Mr. A, who elected to receive benefits currently, minimizing the plan value in his potential estate, is clearly entitled to exclude any remaining plan benefits from his taxable estate under the effective date exception. Many would say, however, that Mr. B is not entitled to the exclusion because he elected deferred benefits and therefore was not "in pay status" on December 31, 1982. The unfairness is obvious: Mr. A who did not rely on the estate tax exclusion and probably will not have much use for it is entitled to it, while Mr. B who relied on the exclusion and made an irrevocable election that increased his potential estate now has the exclusion withdrawn. The bitter pill may be even harder to swallow because, depending on the exact form of the irrevocable beneficiary designation, the benefits may not qualify for the marital deduction even if Mrs. B survives Mr. B. For example, if Mr. B had irrevocably elected fixed monthly payments for the joint lifetime of he and his spouse, followed by benefits to their children, the benefits passing to Mrs. B would be a terminable interest not qualifying for the marital deduction. *See* I.R.C. 2056(b). Moreover, if Mr. B dies now, no plan benefits will be available to help pay the estate tax due to the election to defer benefits. One could hardly blame Mr. B and an unknown number of similarly situated retirees if they feel that excluding them from the effective date exception provided to Mr. A stand fairness on its head.

III. PROPOSED REPEAL OF SECTIONS 2039(C) AND 2517

The non-employee spouse's community property interest in an employee plan can result in unfair estate and gift tax results for residents of community property states. Although one-half the plan values would be considered property of the non-employee spouse, there is no acceleration of benefits following that spouse's death. If an estate tax was imposed at that time on plan values, those values would not be available to help pay that tax. In Texas, plan assets are not part of the probate estate and, as a result, the non-employee spouse has no ability to direct the disposition of the community share of those assets at death.

Section 2039(c) (formerly 2039(d)) of the Code prevents inequitable treatment of residents of community property states by excluding the community interest from the gross estate of the non-employee spouse who predeceases the plan participant. TEFRA

eliminated the general section 2039(c) estate tax exclusion for plan benefits in excess of $100,000, but pointedly did not limit the exclusion for the community property interest under section 2039(d). See I.R.C. § 2039(g) (prior to repeal by the Deficit Reduction Act). Undoubtedly, Congress recognized that even if plan benefits were to be taxed in the estate of the employee, it would still be unfair to tax benefits at the time when the non-employee spouse predeceased the employee. As originally passed by the Senate, the Deficit Reduction Act repealed the community property rule of former subsection 2039(d) along with the general estate tax exclusion of former subsection (c). *See* H.R. 4170 § 90(a) (as passed by the Senate). The Committee of Conference, however, intentionally reinstated the exception for the community property interest of the non-employee spouse. Thus, two Congresses have previously determined that the non-employee spouse exemption should be retained even where the general exclusion for qualified plan benefits has been eliminated.

Now, a third attempt is made to tax qualified plan benefits on the earlier death of the non-employee spouse. H.R. 1800 § 152(e). This time a policy proposal masquerades as a technical correction. What lays behind the mask, however, is neither technical nor a correction. Instead, it is an attempt to change a sensible and equitable provision that has been endorsed by the last two Congresses. This legislative "Trojan horse" needs to be turned back again.

A proposal is also included in H.R. 1800 that would repeal section 2517 of the Code, which provides that the participant's selection of a form of benefits and designation of a beneficiary do not result in gift tax. Congress should carefully consider whether this sweeping change makes sense. The result is likely to be many inadvertent taxable gifts that will go unreported by unsuspecting donors. In general, a participant now includes the value of plan benefits in his estate even if he designates a beneficiary irrevocably during his lifetime. See I.R.C. § 2039(a). It is difficult to identify a tax policy that requires this tax be accelerated by the repeal of section 2517.

If the general exclusion provided by section 2517 of the Code is to be repealed, the special rule in subsection (c) governing community property interests should be retained. Imposing a gift tax on the non-employee spouse when benefits under a qualified plan are transferred would create unfair and even bizarre results. For example, suppose a plan participant chooses to receive an annuity for his life followed by an annuity in trust for his surviving non-employee spouse with a remainder to his children. If, upon the participant's death, the non-employee spouse does not insist that half the benefits be removed from the trust, she has made a transfer and, without a provision such as section 2517(c) of the Code, she would be subject to a gift tax at that time.

It should be noted that the staff of the Joint Committee on Taxation apparently recognizes that the proposals to repeal sections 2039(c) and 2517 would accelerate the inclusion of plan benefits in the estates of residents of the community property states. The staff asserts, however, that to ameliorate the problem the bill would "clarify" that a maritial deduction would be available. Joint Committee on Taxation, *Description of the Technical Corrections Act of 1985 (H.R. 1800 and S. 814)*, JCS-7-85 at 96 (1985). Unfortunately, no clarification is found in the bill. In fact, substantial statutory revisions to sections 2056 and 2523 would be required to provide a marital deduction everywhere it would be needed.

IV. PROPOSED TECHNICAL CORRECTIONS TO RETIREMENT EQUITY ACT

The provisions of § 417 of the Code added by the REA require the non-employee spouse to consent if a participant elects to waive the otherwise required joint and survivor annuity at the participants retirement or the pre-retirement death benefit should the participant die before retirement. I.R.C. § 417(a)(2). The principles of section 2617 of the Code lead to the conclusion that electing to take less than what is otherwise provided by a qualified plan is a gift. Thus, this consent will be a gift and taxable as such unless the Code is amended to provide otherwise. The gift may not be complete at the time of waiver, but when complete it will be taxable to the consenting spouse unless it somehow qualifies for the marital deduction. It is not clear how this is accomplished since the "gift" many benefit persons other than the spouse (e.g., children). A correct federal estate tax return cannot be filed for the non-employee spouse unless the lifetime taxable gifts are correctly reported. Section 2517 of the Code should be expanded to exclude this consent from taxable transfers.

Finally, it should be made clear whether a non-employee spouse's community property rights in the employee's qualified plan are coterminous with the 50 percent annuity under section 417. Otherwise, the non-employee spouse in a community property state may be entitled to more than 50 percent of the plan values accrued on account of the employee's service.

PATTON, BOGGS & BLOW,
Washington, DC, June 7, 1985.

Re Technical Corrections Act of 1985 (H.R. 1800)—original issue discount on tax-exempt bonds.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means, House of Representatives, Washington, DC.

DEAR MR. CHAIRMAN: This letter is submitted on behalf of our client E.F. Hutton & Co., Inc. for inclusion in the record of the Committee's hearing on the proposed Technical Corrections Act of 1985 (H.R. 1800). For the reasons set forth below, we urge the Committee to consider amending H.R. 1800 to provide that the provisions of the Tax Reform Act of 1984 relating to the treatment of original issue discount ("OID") on tax-exempt bonds will be applicable only with respect to obligations issued after December 31, 1982 (rather than September 3, 1982) and acquired after March 1, 1984.

BACKGROUND

For many years, OID on a tax-exempt bond (i.e., the excess of the face value of the bond at maturity over the price at which it is originally issued) was treated by the Internal Revenue Service as tax-exempt interest under section 103 of the Internal Revenue Code. In addition, the Service took the position in a published ruling (Rev. Rul. 73-112, 1973-1 C.B. 47) that OID on a tax-exempt bond was required to be apportioned on a straight-line basis among the original and subsequent holders (if any) of the bond. At the time Rev. Rul. 73-112 was issued, section 1232 of the Code applied the same ratable accrual method to OID on taxable bonds.

In the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), Congress amended the Code to require use of a so-called "constant interest method" for calculating OID on bonds issued after July 1, 1982 by corporations and certain other entities. Congress did not, however, explicitly amend the Code to prescribe comparable treatment for OID on tax-exempt bonds. Indeed, it is understood that, on July 12, 1982, the Senate Finance Committee removed tax-exempt bonds from the application of the new statutory rules. Moreover, the committee reports that comprise the official legislative history of TEFRA do not expressly state that Congress intended the TEFRA rules to be applied to tax-exempt bonds.

While there appears to have been some uncertainty in the private sector whether a similar change was to be "implied" for tax-exempt bonds, the Service did not revoke Rev. Rul. 73-112 and numerous issues of tax-exempt bonds (including so-called "zero coupon" bonds) proceeded on the basis that the ratable accrual method should continue to apply to tax-exempt bonds.

On December 31, 1982, the staff of the Joint Committee on Taxation issued its "General Explanation" of TEFRA, which included (at page 162) the statement that "Congress intended that the new nonlinear formula for accrual of OID also apply . . . in determining accrual on State and local bonds."

TAX REFORM ACT OF 1984

In sections 41 and 43 of the Tax Reform Act of 1984, Congress added to the Code a provision (section 1288) a provision explicitly requiring the use of the constant interest method for OID on tax-exempt bonds. Under this statutory change, less tax-exempt interest would accrue early in the bond term and more would accrue later in the bond term, thus reducing the likelihood that the holder of a tax-exempt bond issued at a deep discount could claim a tax loss (while having an economic gain) by selling the bond before maturity. This statutory change was made on a partially retroactive basis, i.e., it was applied to bonds issued after September 3, 1982 (the date of enactment of TEFRA) and acquired after March 1, 1984.

EFFECTIVE DATE

The rationale for the retroactive effective date appears to have been that Congress "intended" the TEFRA rules to apply to tax-exempt bonds. However, as noted above, the first published statement to that effect did not appear until December 31, 1982, nearly four months after the date on which TEFRA was enacted. Although some may have anticipated that the TEFRA changes for taxable bonds might be taken implicitly to suggest a comparable change for tax-exempt bonds, the absence of any published statement to the effect until December 31, 1982 should be given great weight in setting the effective date for the 1984 changes.

For these reasons, we urge the Committee to consider amending H.R. 1800 to include a provision limiting the application of the referenced 1984 changes to tax-exempt bonds issued after December 31, 1982 and acquired after March 1, 1984.

Very truly yours,

DONALD V. MOOREHEAD,
(On behalf of E.F. Hutton & Co., Inc.)

STATEMENT OF

INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA

AND

AMERICAN ASSOCIATION OF PETROLEUM LANDMEN
ARKOMA BASIN INDEPENDENT GAS PRODUCERS ASSOCIATION
CALIFORNIA INDEPENDENT PRODUCERS ASSOCIATION
EASTERN KANSAS OIL AND GAS ASSOCIATION, INC.
ILLINOIS OIL AND GAS ASSOCIATION
INDEPENDENT OIL AND GAS ASSOCIATION OF WEST VIRGINIA
INDEPENDENT OIL PRODUCERS TRI-STATE, INC.
INDEPENDENT PETROLEUM ASSOCIATION OF MOUNTAIN STATES
INDEPENDENT PETROLEUM ASSOCIATION OF NEW MEXICO
INDIANA OIL AND GAS ASSOCIATION
KENTUCKY OIL AND GAS ASSOCIATION
LIAISON COMMITTEE OF COOPERATING OIL AND GAS ASSOCIATIONS
LOUISIANA LANDOWNERS ASSOCIATION, INC.
LOUISIANA ASSOCIATION OF INDEPENDENT PRODUCERS AND ROYALTY OWNERS
MICHIGAN OIL AND GAS ASSOCIATION
NATIONAL STRIPPER WELL ASSOCIATION
NEW YORK STATE OIL PRODUCERS ASSOCIATION
NORTH TEXAS OIL AND GAS ASSOCIATION
OHIO OIL AND GAS ASSOCIATION
OKLAHOMA INDEPENDENT PETROLEUM ASSOCIATION
PANHANDLE PRODUCERS AND ROYALTY OWNERS ASSOCIATION
PENNSYLVANIA GRADE CRUDE OIL ASSOCIATION
PENNSYLVANIA OIL AND GAS ASSOCIATION
PERMIAN BASIN PETROLEUM ASSOCIATION
ROYALTY OWNERS AND INDEPENDENT OIL AND GAS PRODUCERS ASSOCIATION OF ARKANSAS
TENNESSEE OIL AND GAS ASSOCIATION
TEXAS INDEPENDENT PRODUCERS AND ROYALTY OWNERS ASSOCIATION
VIRGINIA OIL AND GAS ASSOCIATION
WEST CENTRAL TEXAS OIL AND GAS ASSOCIATION

Technical Corrections Act

of 1985

(H.R. 1800; S. 814)

ITEM 1
CORRECTION OF STATUTE OF LIMITATIONS ON ASSESSMENT AND COLLECTION PROVISIONS DEALING WITH THE WPT

BACKGROUND AND DESCRIPTION OF ITEM

Sec. 6501 prescribes rules governing application of the statute of limitations in the case of assessment and collection of tax. Generally, the statute of limitations for assessment and collection of tax is three years after the return is filed. In the case of oil producers whose production is subject to withholding of WPT and with respect to which no return (i.e., annual Form 720) is required, the "return" referred to in Sec. 6501(a) is the income tax return for the taxable year in which the removal year ends (Sec. 6501(p)(1)(A)).

Rev. Rul. 85-37, recently issued by the Internal Revenue Service (IRS), illustrates the application of the statute of limitation provisions in cases of assessment and collection (Sec. 6501) and on credits or refund (Sec. 6511) of WPT in four factual situations. A contrasting of situations 3 and 4 in Rev. Rul. 85-37 indentifies the nonsymmetrical application of Secs. 6501 and 6511 when no annual Form 720 is filed. When an overpayment occurs and no annual Form 720 is filed (situation 3), the statute of limitation for credit or refund is three years from the due date of the income tax return for the taxable year in which the removal year ends. When an underpayment occurs and no annual Form 720 is filed (situation 4), however, the underpayment may be assessed at any time, as Sec. 6501(p)(1)(A) is inoperable (a "return" (annual Form 720) was required).

Many small independent oil and gas operators (particularly on nonoperated properties where the operator furnishes information to the purchaser under Reg. 51.6050C-1), as a practical administrative matter, rely, in "good faith", on the annual Form 6248 filed by the first purchaser to determine whether or not their WPT obligation (prior to application of the net income limitation) has been satisfied by withholding. Because of the operation of Sec. 6501, however, these innocent taxpayers, in essence, may have an unlimited statute of limitations in the event, for example, of an inadvertent property misclassification or utilization of an incorrect adjusted base price.

RECOMMENDED TECHNICAL CORRECTION

We recommend the following statutory change to Sec. 6501(p):

1. Redesignate Sec. 6501(p)(1)(B) as Sec. 6501(p)(1)(C), and add new Sec. 6501(p)(1)(B), as follows:

   "(B) SAFE HARBOR RULE IN GOOD FAITH SITUATIONS. - If a taxpayer in good faith determined that no return for a removal year (as defined in Sec. 6501(p)(1)(C)) was required, but it is subsequently determined that, in fact, a return was required, the period for assessing any deficiency for such removal year shall expire 3 years from the date the return was otherwise originally due."

We recommend that this technical correction item, if adopted, be retroactive to the enactment of the Crude Oil Windfall Profit Tax Act of 1980 (P.L. 96-223).

ITEM 2
PROHIBITION OF DOUBLE TAX DETRIMENT IN DETERMINING ITEMS OF TAX PREFERENCE

BACKGROUND AND DESCRIPTION OF ITEM

Sec. 57(a)(8) generally provides that the excess of percentage depletion over the adjusted basis of the property at the end of the year is an item of tax preference. Sec. 57(a)(11)(A) generally provides that the amount (if any) by which the amount of excess IDC is greater than net income from oil and gas is an item of tax preference. In determining the net income from oil and gas

offset under Sec. 57(a)(11)(C), gross income must be offset by the "amount of any deductions" allocable to the property (Sec. 57(a)(11)(C)(ii)). Since percentage depletion (in excess of adjusted basis) must apparently be deducted against gross income under Sec. 57(a)(11)(C) (thus increasing the tax preference amount under Sec. 57(a)(11)), taxpayers may be inequitably penalized through what in effect constitutes a "double counting" of items of tax preference.

Despite the issuance of Rev. Rul. 84-124, addressing the interrelationship between the capital gain preference and the excess itemized deduction preference (prior law), it is not completely clear whether Sec. 58(h) will operate to eliminate this "double counting" of preference items. Recently, the Tax Court, in passing, expressed reservation as to whether Sec. 58(h) applies in the context of the alternative minimum tax (AMT) (Howard Y. Huntsberry, 83 TC No. 42 (11-26-84)). Thus, the application of Sec. 58(h) to correct this inequity is unsettled.

RECOMMENDED TECHNICAL CORRECTION

We recommend the following statutory change to Sec. 58(h):

1. Change the title of Sec. 58(h) to:

   "SPECIAL RULES IN DETERMINING ITEMS OF TAX PREFERENCE"

2. Redesignate Sec. 58(h) as Sec. 58(h)(1).

3. Add new Sec. 58(h)(2), as follows:

   "(2) NO DOUBLE COUNTING OF PREFERENCES. - For purposes of this part, items of tax preference which influence the determination of another item of tax preference shall be considered only once."

We recommend that this technical correction item, if adopted, be retroactive to the enactment of the Tax Reduction and Simplification Act of 1977 (P.L. 95-618).

ITEM 3
APPLICATION OF 90 DAY ECONOMIC PERFORMANCE RULE TO ACCRUAL BASIS TAXPAYERS AND TOLLING OF 90 DAY PERIOD IN CASE OF RESTRICTIONS IMPOSED BY GOVERNMENT AUTHORITIES

BACKGROUND AND DESCRIPTION OF ITEM(S)

Prepayments Made by Accrual-Basis Taxpayers

Prior to the Tax Reform Act of 1984 (the "Act") an accrual-basis taxpayer could deduct the amount of a liability if all the events that fixed the liability had occurred and the amount could be determined with reasonable accuracy, even though the taxpayer had not yet expended monies to pay the expense or performed his obligation. These criteria are generally referred to as the "all events" test. Several court cases prior to the enactment of the Act held that an accrual-basis taxpayer was permitted to deduct prepaid intangible drilling and development costs under Section 263(c) where payment was made pursuant to a binding contract requiring payment before year-end. George Cheroff, 40 T.C.M. 83 (1980); Dillingham v. U.S., 81-2 USTC 9601 (W.D. Okla. 1981). The rationale of these pre-Act decisions would generally be equally applicable to prepayments made by taxpayers engaged in economic activities other than oil and gas exploration and development.

Under Section 461(h) as added by the Act, an accrual-basis taxpayer is not entitled to a deduction until the all events test is satisfied and economic performance has occurred. Generally, when services are provided to the taxpayer, economic performance occurs when the services are performed. Section 461(h) does not contain a "90 day rule," discussed below, similar to Section

461(i)(2). Thus, for example, an accrual-basis taxpayer (whether or not a tax shelter) who has executed a drilling agreement for the performance by another of intangible drilling and development services and has paid for such services in advance, may not deduct the cost of such services until they are performed.

The economic performance requirement of the Act does not apply to cash-basis taxpayers that are not tax shelters. The Act added Section 461(i)(1) which provides that cash-basis tax shelters are subject to the economic performance rules in determining the amount of allowable deductions. For cash-basis tax shelters, however, an exception under Section 461(i)(2) is made for any item if economic performance with respect to such item occurs within 90 days after the close of the taxable year (which, under the Technical Corrections Bill of 1985, would be changed to read "before the close of the 90th day after the close of the taxable year"). Thus, for example, a cash-basis taxpayer which is not a tax shelter who has executed a drilling agreement for the performance of intangible drilling and development services and has paid for such services in advance, may generally deduct the cost of such services in the year of prepayment. A cash-basis tax shelter taxpayer may deduct the cost of such services provided economic performance occurs before the close of the 90th day after the close of the taxable year.

Congress, in the legislative history of the Act, expressed concern over recent court decisions which permitted accrual-basis taxpayers to deduct as current expenses items that were not yet "economically incurred". Congress' concern was that a current deduction for such items overstated their cost to the taxpayer because the time value of money was not considered:

> Allowing a taxpayer to take deductions currently for an amount to be paid in the future overstates the true cost of the expense to the extent that the time value of money is not taken into account; the deduction is overstated by the amount by which the face value exceeds the present value of the expense.

Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 260 (1984). The economic performance requirement under Section 461(h), however, applies to all deductions claimed by an accrual-basis taxpayer, whether or not the deduction involves any time value of money benefit. The legislative history of Section 461(h) does not address the possibility of an accrual-basis taxpayer incurring and paying for expenses prior to their actual performance.

There appears to be no economic or legal reason, in our opinion, to treat accrual-basis taxpayers differently than cash-basis taxpayers. Our proposed technical correction provides symmetry between cash-basis and accrual-basis taxpayers.

Tolling of 90-day Period Due to Government Restriction or Regulation

A practical problem in allowing a deduction for cash-basis tax shelters if economic performance occurs before the close of the 90th day after the close of the taxable year is that many oil and gas producing states have laws or administrative regulations that reduce weight limits on highways after the winter freezes in order to reduce damage that occurs during periods of thawing ("frost laws"). These frost laws preclude heavy exploration and development equipment (such as drilling rigs) from obtaining access to drill sites for most of the first 90 days of each year and generally for most of the first 120 days. The following proposal incorporates a tolling of the 90 day period during times when such frost laws are in effect. Attached is a memorandum (Exhibit I) addressing the problems Ohio oil and gas producers face because of the frost laws; however, because of the similarity in climate, the memorandum applies equally to the following states with similar laws: Michigan, Illinois, Indiana, Kentucky, West Virginia, Pennsylvania and New York.

RECOMMENDED TECHNICAL CORRECTION

Proposal Relating to Prepayments Made by Accrual-Basis Taxpayers

Section 461(h) is amended by redesignating paragraphs (3), (4) and (5) as (4), (5), and (6), respectively, and by adding immediately after paragragh (2), the following paragraph:

"(3) PAYMENT PRECEDES ECONOMIC PERFORMANCE. -

(A) IN GENERAL. - Paragraphs (1) and (2) shall not apply if -

(i) the all events test with respect to such item is met during the taxable year (determined without regard to paragraph (1)), and

(ii) payment is made prior to the end of the taxable year.

(B) TAX SHELTER TAXPAYERS. - In the case of a tax shelter taxpayer (as defined by Section 461(i)(3)), subparagraph (A) shall not apply unless economic performance (as defined by Section 461(h)(2)(A) and (B)) with respect to such item occurs before the close of the 90th day after the close of the taxable year. For purposes of the preceding sentence, the provisions of Section 461(i)(2) (other than paragraph (A) thereof) and Section 461 (i)(4) shall apply."

Proposal Relating to Tolling of 90 day Period Due to Government Restriction or Regulation

Section 461 is amended by adding the following sentence at the end of subparagraph (A) of Section 461(i)(2):

"In determing the 90 day period, there shall be excluded those days during which economic performance is precluded from being performed due to federal, state, or local governmental restrictions or regulations."

EXHIBIT I

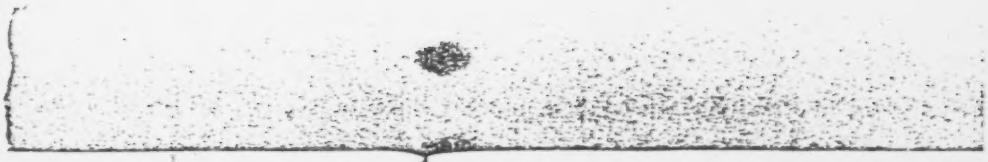
FROST LAWS THAT RESTRICT DRILLING OPERATIONS

Section 5577.07 of the Ohio Revised Code, a copy of which is attached as Exhibit A, authorizes the Director of Transportation and County Commissioners to prescribe reduced maximum weights on vehicles on roads during times of thaws and moisture. The Director of Transportation is authorized to reduce maximum weights on state highways, and the Boards of County Commissioners are authorized to prescribe reductions on all of the roads within their counties. In general, the State of Ohio has not imposed weight reduction limits on state highways. However, counties have imposed weight reductions on both county and township roads. Generally, the county engineers recommend the dates that the restrictions are imposed and lifted. These recommendations are adopted by resolutions of the County Commissioners or Township Trustees. These restrictions are commonly referred to as "frost laws."

In Ohio, as well as other states, oil and gas operations can be interrupted during the months of January through May because of weight restrictions imposed by county and township authorities on the use of county and township roads during these months. The restrictions imposed by county and township authorities are reduction in weight limits for vehicles to use these highways because of the winter thaw of frozen ground. In general, county and township highways are not constructed in the same manner as state or federal highways and cannot support the same weight limits. After the winter freeze and at the beginning of the thawing season, the ground under the county and township roadways is very soft. Weight reduction restrictions are imposed to reduce the likelihood of damage to the roadways. Heavy vehicles used in oil and gas development such as drilling rigs are affected by the reduction in the weight limits and are precluded from gaining access to many drilling sites.

As previously stated, weight reductions are imposed on a county by county or township basis. Therefore, there is no general rule as to when such restrictions are imposed or lifted. Information relating to ten of the most active Ohio counties for oil and gas development has been compiled for the last five years. Exhibit B, attached hereto, sets forth information relating to the number of wells drilled in Ohio and the number of wells drilled in each of the representative counties. Exhibit C, attached hereto, sets forth information relating to weight reduction percentage, the date of imposing weight restrictions, and the date such restrictions were lifted in the representative counties.

As illustrated on Exhibit C, weight reduction has been imposed as early as January in some counties and certainly by February in all counties in each of the last five years. The restrictions are generally lifted by mid-April to early May. In many areas of Ohio, an oil and gas developer would be precluded from commencing the drilling of wells or spudding wells during that period of time in those areas in which county and township roads are the only access to drilling sites. This is a significant reduction in the ability of oil and gas producers in Ohio and other states to avail themselves of the "90 day rule" set forth in Section 461(i)(2) of the Code. In essence, there are regions in Ohio which are completely precluded from using the 90 day rule, and, in certain areas, the rule could be used only if drilling commenced prior to the frost law date, which might be within 15 or 30 days after the end of the taxable year.



fected shall have the same right of appeal as provided in such sections.

This section does not require the state, a municipal corporation, county, township, or any railroad or other private corporation to provide sufficient vertical clearance to permit the operation of such vehicle, or to make any changes in or about existing structures now crossing streets, roads, and other public thoroughfares in this state.

*HISTORY: 133 v H 200 (Eff 9-28-73); 136 v H 624 (Eff 11-26-75); 137 v H 1 (Eff 8-26-77); 137 v S 207 (Eff 10-21-77); 138 v S 22 (Eff 9-19-79); 139 v S 436 (Eff 8-26-82); 140 v H 448, Eff 12-19-83.

The effective date of HB 448 is set by § 3 of the act.

The provisions of § 4 of HB 448 (140 v —) read as follows:

SECTION 4. The cards authorized by section 5577.05 of the Revised Code shall be available to the owners of semitrailers, as provided in that section, no later than thirty days after the effective date of this act. Failure of an operator to display such a card during the sixty-day period immediately following the effective date of this act shall not be construed as constituting the unlawful operation of any semitrailer fifty-three feet long in a commercial tractor-semitrailer combination, except on highways where such operation has been prohibited by the Director of Transportation pursuant to this act.

CASE NOTES AND OAG

1. This section releases a municipality from any obligation to provide vertical clearance for maximum size vehicles. Robert Neff & Sons v. Lancaster, 21 OS2d 31, 36, 50 OO2d 80, 254 NE2d 693.

2. (1973) A unit consisting of a commercial tractor, semitrailer and solidly attached four-wheel trailer, is a "commercial tractor and semitrailer combination" within the meaning of RC § 5577.05(B)(3), and limited to an overall length of fifty-five feet. OAG No. 73-009.

3. (1975) A power unit specially designed to carry automobiles independent of those transported on an attached semitrailer is a commercial car, as defined in RC § 4501.01(G), for purposes of determining the allowable length of the power unit in combination with a semitrailer under RC § 5577.05(B). OAG No. 75-045.

§ 5577.06 Prohibition against violation.

No person shall violate any rule or regulation promulgated by the director of transportation in accordance with section 5577.05 of the Revised Code.

*HISTORY: 133 v H 200. Eff 9-28-73.

§ 5577.07 Reduction of weight and speed during times of thaws and moisture.

When thaws or excessive moisture render the improved highways of this state or any sections of them insufficient to bear the traffic thereon, or when such highways would be damaged or destroyed by heavy traffic during the period of thawing or excessive moisture, the maximum weight of vehicle and load, or the maximum speed, or both, for motor vehicles, as prescribed by law shall be reduced in the following manner:

(A) On state highways, the director of transportation shall prescribe such reduction which shall not be more than twenty-five per cent;

(B) On improved highways and all other roads in the county, other than state highways, the board of county commissioners shall prescribe such reduction as the condition of the road or highway justifies, but in no case shall the reduction be more than fifty per cent.

The schedule of the reduction of maximum weights and speeds shall be filed, for the information of the public, in the office of the board of each county in which the schedule is operative and in the office of the director. The director or board, at least one day before such reduction becomes effective, shall cause to be placed and retained on such highways, at both ends and at the points of intersections by principal roads, during the period of such reduced limitation of weight, speed, or both, signs, of substantial construction, which will conspicuously indicate the limitations of weight and speed, which are allowed on the highway and the date on which such limitations shall go into effect. No person shall operate upon any such highway, a motor vehicle whose maximum weight or speed is in excess of the limitations prescribed. The expense of the purchase and erection of signs, provided for in this section, shall be paid from funds for the maintenance and repair of roads.

*HISTORY: 133 v H 200. Eff 9-28-73.

§ 5577.08 Classification of roads by board of county commissioners.

CASE NOTES AND OAG

1. (1979) The provisions of RC § 5577.08, requiring the board of county commissioners to classify roads and make rules and regulations governing weight and speed of vehicles weighing more than five tons on all improved roads within the county, except state highways, are mandatory. The provisions of RC Chapter 5577 with regard to maximum weight, length, width, and height are applicable and enforceable as to vehicles traveling on any improved street, highway, bridge, or culvert within this state, irrespective of whether county commissioners have complied with RC § 5577.08. OAG No. 79-035.

§ 5577.12 Liability for damages; prosecution; application of moneys.

Any person violating any law relating to or regulating the use of the improved public roads shall be liable for all damage resulting to any such street, highway, bridge, or culvert by reason of such violation. In case of any injury to such a street, highway, bridge, or culvert, such damages shall be collected by civil action, brought in the name of the state, on

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*HISTORY: 133 v H 200. E

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Law Review
Highway Load Limits

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EXHIBIT B

Ten Most Active Counties (with Number of Wells Drilled)

Year	Total Number of Wells Drilled in Ohio	1	2	3	4	5	6	7	8	9	10
1980	3,356	Muskingum (366)	Washington (342)	Portage (259)	Trumbull (236)	Holmes (230)	Coshocton (221)	Perry (191)	Ashtabula (168)	Licking (112)	Morgan (110)
1981	5,425	Washington (559)	Muskingum (404)	Holmes (384)	Stark (319)	Portage (314)	Coshocton (313)	Perry (292)	Licking (232)	Trumbull (231)	Morgan (228)
1982	4,642	Wayne (337)	Washington (325)	Muskingum (312)	Holmes (310)	Coshocton (230)	Portage (205)	Medina (202)	Morgan (201)	Perry (196)	Astabula (182)
1983	6,165	Perry (455)	Muskingum (406)	Wayne (316)	Coshocton (310)	Washington (297)	Morgan (284)	Trumbull (269)	Licking (246)	Holmes (244)	Medina (234)

EXHIBIT C

ENACTMENT OF FROST LAWS OVER PAST FIVE YEARS BY TEN MOST ACTIVE OHIO COUNTIES

County	Year	Date Enacted	Percentage Reduction	Date Removed	Comments
Coshocton	N/A	N/A	N/A	N/A	Does not enact frost laws because they are too hard to enforce.
Holmes	1980	Mid-February	25%	Early May	All county roads only.
	1981	Mid-February	25%	Early May	
	1982	Mid-February	25%	Early May	
	1983	Mid-February	25%	Early May	
	1984	Mid-February	25%	Early May	
Licking	1980	Early February	Up to 50%	Mid-April	Certain county roads only. Several resolutions passed each year, and each resolution affects only a few county roads.
	1981	Early February	Up to 50%	Mid-April	
	1982	Early February	Up to 50%	Mid-April	
	1983	Early February	Up to 50%	Mid-April	
	1984	Early February	Up to 50%	Mid-April	
Medina	1980	No info.	No info.	No. info.	All county and township roads.
	1981	January 15	25%	May 1	
	1982	January 15	25%	May 3	
	1983	January 15	25%	May 2	
	1984	January 15	25%	May 1	
Morgan	1980	N/A	N/A	N/A	All county roads. Township roads for 1983 and 1984. No records indicating whether frost laws enacted in 1980-82.
	1981	N/A	N/A	N/A	
	1982	N/A	N/A	N/A	
	1983	January 24	30%	April 30	
	1984	January 23	30%	April 30	
Muskingum	1980	January 25	30%	May	Certain county roads only.
	1981	January 25	30%	May	
	1982	January 25	30%	May	
	1983	January 25	30%	May	
	1984	January 25	30%	May	

County	Year	Date Enacted	Percentage Reduction	Date Removed	Comments
Perry	1980	January 6	50%	April 30	All county and township roads.
	1981	January 8	50%	April 30	
	1982	February 1	50%	No info.	
	1983	February 14	50%	April 30	
	1984	February 15	50%	April 30	
Trumbull	1980	January	No info.	April	All county and township roads.
	1981	January	No info.	April	No records maintained of dates
	1982	January	No info.	April	and percentage reductions.
	1983	January	No info.	April	Bond and/or loading permit
	1984	January	No info.	April	required during reduction period.
Washington	1980	March 11	50%	April 30	Most county and township roads.
	1981	February 23	50%	April 15	
	1982	February 1	50%	No info.	
	1983	January 25	50%	April 15	
	1984	January 24	50%	April 15	
Wayne	1980	February 1	25%	May	Certain county roads only.
	1981	February 1	25%	May	
	1982	February 1	25%	May	
	1983	February 1	25%	May	
	1984	February 1	25%	May	

INDIANA MUNICIPAL POWER AGENCY,
Indianopolis, IN, May 28, 1985.

Re Comments on certain provisions of the Technical Corrections Act of 1985—H.R. 1800 and S. 814.

MEMBERS OF THE WAYS AND MEANS COMMITTEE OF THE UNITED STATES HOUSE OF REPRESENTATIVES,[1]
MEMBERS OF THE FINANCE COMMITTEE OF THE UNITED STATES SENATE,[1] AND
MEMBERS OF THE INDIANA CONGRESSIONAL DELEGATION.[1]

LADIES AND GENTLEMEN: We welcome this opportunity to comment on the provisions of the Technical Corrections Act of 1985 ("Act") that amend Section 103(o) of the Internal Revenue Code of 1954, as amended ("Code") and the staff explanation accompanying that provision. As provided for in Press Release #10 of April 22, 1985 and the Senate Finance Committee Release of May 8, 1985, we would ask that our comments be included in the record of the Ways and Means Committee and the Finance Committee, respectively. We request that the proposed amendment to Section 103(o) be rejected but that Section (o) be amended to make clear that its provisions do not adversely impact upon the issuance of tax exempt obligations to finance municipal ownership of electric power generation and transmission as now permitted by Section 103(a) of the Code.

When Congress adopted the Tax Reform Act of 1984, it was our understanding that Congress intended to limit the use of bond proceeds for the purchase of making loans to consumers and that Congress expressed this intent by enacting Section 103(o). Unfortunately, the precise language of that section can be read more broadly to include any arrangement between an issuer of bonds and a person that is not an exempt person within the meaning of Section 103(b)(3) of the Code ("non-exempt persons"), if that arrangement can be construed as an indirect loan of bond proceeds.

We point out that, despite our confidence that provisions of Section 103(o) were intended to reach only true consumer loans, the actual language of those provisions has been interpreted by many attorneys serving public power agencies to apply to many power transactions because of the literal language of the statute. Obviously, this situation has a chilling effect on the ability of public power suppliers to consummate transactions, especially because the concept of an indirect loan is not adequately set forth in the statute and has not been elucidated in Treasury Regulations ("Regulations"). We also point out that the Department of the Treasury ("Treasury") and staff must have recognized that many observers feel that it was Congressional intent to affect only true consumer loans. Otherwise there would have been no need for Congress to change the language in Section 103(o) to restrict "private loan bonds" nor would there have been a necessity for staff commentary accompanying the Act that indicates a clear intent to reach transactions beyond true consumer loans.

Due to the lack of clarity in the law and questions about Congressional intent, many issuers of municipal bonds requested the Treasury to implement Regulations explaining that section so that municipal issuers could have some assurance that arrangements with non-exempt persons who were not consumers were not covered by the Act and have some idea what the Treasury would consider an indirect loan. Proposed regulations have not been forthcoming. Instead, the Act makes clear that all private loans, including all loans to non-exempt persons other than consumers, involving more than a significant portion of the proceeds of a particular bond issue will not bear interest that is tax exempt under Section 103(a) of the Code. Earlier staff commentary on Section 103(o) indicates that any amount in excess of 5% constitutes a significant portion. In addition, the proposed amendment to Section 103(o) does not clarify the question of what constitutes an indirect loan and, therefore, leaves issuers of tax exempt bonds in a position of uncertainty and waiting for the promulgation of Regulations to explicate those provisions, assuming any such Regulations will ever be forthcoming.

Our view is that Congress should indeed amend Section 103(o) to clarify their intent that its provisions apply only to bond proceeds that are actually loaned to consumers rather than to other non-exempt persons. We are persuaded that this was Congressional intent in first enacting the statute and that this intent should not be undermined in the guise of "technical corrections" to the Code.

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[1] Lists of members omitted.

The Indiana Municipal Power Agency ("IMPA") is a political subdivision of the State of Indiana that provides power and energy to its 25 municipal members. These members are municipalities with a population of 250,000 and utilities that currently provide services to approximately 130,000 retail customers. These municipalities have been providing services to customers for decades and, in some instances, since the 19th century. These municipalities and agencies like IMPA have been able to serve the public purpose of providing electricity to consumers by financing facilities for the generation and transmission of electricity through the issuance of tax exempt bonds. The Indiana Supreme Court has long recognized the public purpose served by this provision of electrical service.

IMPA was formed to allow the member municipalities to collectively negotiate for the purpose of power with other utilities and to collectively purchase generation and transmission facilities to provide those members with the economies of scale in the electric utility industry that have long been enjoyed by investor-owned utilities as opposed to each small municipal utility operating its own, relatively inefficient system.

Under the current provisions of the Code and the Regulations promulgated under Section 103(b), IMPA may issue its bonds for generation or transmission and distribution facilities and enter into arrangements with non-exempt persons as a co-owner of those facilities. The contractual arrangements between IMPA and a non-exempt person typically allow IMPA to provide for expected growth in generation needs of its members by investing more now to achieve the necessary power supply facilities in the future. For example, if IMPA feels that it will need a certain amount of power in 1995, it might purchase facilities that would provide more than enough power for its members in 1986 but would provide, on an estimated basis, adequate power in 1995. This type of planning is traditional and necessary in the electric utility industry because of the long lead time required to build facilities to serve future needs. The current provisions of the Code and those Regulations recognize the advisability of allowing IMPA to sell back power from the facility until IMPA and its members need that power, assuming the other requirements of the Regulations are met, to non-exempt persons. See Regulation 1.103-7(b)(5) (attached). As long as IMPA does not sell more than 25% of the power from the facility over an average term set forth in those Regulations, the bonds are not industrial development bonds and are, therefore, eligible for the tax exemption provided under the current provisions of Section 103(a) of the Code. However, if such a sell back arrangement is construed to be a direct or indirect loan of 5% or more of the bond proceeds, the tax exemption would be lost under Section 103(o).

Another potential example of a situation where IMPA's inability to serve the public purpose for which it was created because of the denial of the tax exemption provided by Section 103(a) if the new Section 103(o) is adopted, or if the existing provisions are interpreted to include non-consumer loans, occurs when IMPA desires to purchase transmission or distribution facilities in co-ownership with a non-exempt person. Even where IMPA structures its contract for ownership of those facilities so that IMPA's ownership interest is designed to match its use of the entire transmission system precisely, there are necessarily some payments for services rendered for transmission facilities between the co-owners as transmission fluctuates. Of course, given variations in electric power loads due to weather conditions, among other things, the use of transmission facilities that are co-owned by more than one utility always fluctuates. There is a possibility that IMPA's facilities might be used over a period of time because of those fluctuations by an investor-owned utility, a non-exempt person, and that the Internal Revenue Service would argue that the payment arrangements for such use constitute an "indirect loan" of the bond proceeds used to finance IMPA's facilities if, for that period of time, the non-exempt person's use of IMPA's facilities consisted of 5% or more of those facilities. Obviously, IMPA currently has little guidance on whether these contractual arrangements would be viewed as an indirect loan by the Internal Revenue Service.

The bottom line is that public power accounts for a significant amount of electrical power generated and delivered to consumers throughout the United States and that local governments have traditionally supplied these services to benefit their citizens and residents. The main financing tool used by these providers is municipal bond issues that bear interest that is tax exempt under Section 103(a) of the Code. To maintain the exemption for the types of bonds issued to provide generation and transmission facilities, we would urge that Section 103(o) not be amended in the form proposed and that the definition of consumer loan bond be amended to read: The term "consumer loan bond" means any obligation which is issued as part of an issue all or a significant portion of the proceeds of which are reasonably expected to be used directly or indirectly to make or finance loans (other than loans described

in subparagraph (c)) to persons who are consumers (within the meaning of paragraph (D)).

As a corollary, we would suggest that "consumers" be defined in a new paragraph (D) under Section 103(o) and that such definition accurately reflect the intent of Congress to only affect consumers. For your information, we enclose herewith a definition from the Uniform Commercial Credit Code.

An alternative approach that would protect public power issuers would be to insert a subparagraph (iii) in Section 103(o)(C) that reads:

(iii) consists of a financial arrangement between an exempt person and persons who are not exempt persons (within the meaning of subsection (b)(3)) pursuant to which the exempt person or persons and the person or persons who are not exempt have ownership interests in facilities for the provision of utility services or pursuant to which any payments made by the person or persons who are not exempt have been approved by, or are effective through filing with, any federal or state body with the authority to regulate rates or tariffs.

Of course, if this change were incorporated, the word "or" after subparagraph (i) would have to be deleted and a ", or" would have to replace the period after subparagraph (ii).

A third potential solution would be to clarify the phrase "directly or indirectly to make or finance loans" within Section 103(o). Congress could provide a safe harbor so that public power agencies would at least be able to structure their financings with some degree of certainty. Again, while it could be said that Regulations could be adopted to clarify these provisions, such Regulations have not been forthcoming within a period of almost a year. We would suggest that the concept in the staff explanation of Section 103(o) that was presented after the adoption of the Tax Reform Act of 1984 could be included within this definition of a loan or indirect loan. In essence, those comments indicated that the language of Section 103(o) should be construed to incorporate transactions that were loans in substance if not in form. There are various tests that the Internal Revenue Service has developed to focus on that issue and incorporation of one of those tests could provide such a safe harbor.

If the third alternative is selected, we would suggest that any safe harbor provisions contain specific language, similar to that suggested above for a new (C)(iii), applicable to municipal utilities and public power agencies, that recognize the proposition that no arrangement between a utility that issues municipal bonds and a customer of that utility shall be considered a consumer loan or private loan if payments by the non-exempt persons are pursuant to rates or tariffs filed with or approved by state or federal bodies charged with regulating those rates or tariffs by law.

The suggestions for changes to Section 103(o) outlined above would also protect municipal utilities, including IMPA members, across the country from the threat of having their bond issues rendered taxable because of the consumer loan bond provisions. Municipal utility issuers often have substantial commercial or industrial usage of the services they provide from facilities that were financed with tax exempt bonds. The current Regulations promulgated under Section 103(b) of the Code allow those issuers to provide those services to residential, commercial and industrial users without becoming industrial development bonds and, therefore, in most circumstances, taxable, so long as the facilities financed by the issuance of bonds are available for general public use. Under certain circumstances, the current Section 103(o), or the proposed amendments, can inhibit an issuer from providing new facilities because of the concern that its sale of services to a non-exempt person will be construed as an indirect loan.

These concerns apply not only to municipal electric utilities, but to municipal sewage, water and gas utilities as well. There are hundreds of such utilities in the State of Indiana that have traditionally served municipal customers. These utilities range in size from utilities serving less than 100 customers to utilities serving hundreds of thousands of customers.

We would be happy to answer any questions you might have about these comments or the provisions of Section 103(o) as they apply to public power agencies and municipal electric utilities. Please do not hesitate to call me at 317/849-3242, if you have any such questions or comments. Any technical legal questions should be addressed to our bond counsel, Thomas K. Downs of Ice Miller Donadio & Ryan, at 317/236-2339, or our general counsel, James R. McClarnon of Smith Morgan & Ryan, at 317/636-5401. Kindest regards.

Sincerely,

JESSE C. TILTON III,
General Manager, Indiana Municipal Power Agency.

Attachments.

Caution: Reg. § 1.103-7 does not reflect amendments made to Code Sec. 103 by P. L. 94-455 (Tax Reform Act of 1976), P. L. 97-248 (TEFRA), and P. L. 98-369 (Tax Reform Act of 1984). See ¶ 947.01 et seq.

[¶ 981]—Continued

being used in the trade or business of a nonexempt person in situations involving other arrangements, whether in a single transaction or in a series of transactions, whereby a nonexempt person uses property acquired with the proceeds of a bond issue in its trade or business.

(iii) The use of more than 25 percent of the proceeds of an issue of obligations in the trades or businesses of nonexempt persons will constitute the use of a major portion of such proceeds in such manner. In the case of the direct or indirect use of the proceeds of an issue of obligations or the direct or indirect use of a facility constructed, reconstructed, or acquired with such proceeds, the use by all nonexempt persons in their trades or businesses must be aggregated to determine whether the trade or business test is satisfied. If more than 25 percent of the proceeds of a bond issue is used in the trades or businesses of nonexempt persons, the trade or business test is satisfied. For special rules with respect to the acquisition of the output of facilities, see subparagraph (5) of this paragraph.

(4) *Security interest test.* The security interest test relates to the nature of the security for, and the source of, the payment of either the principal or interest on a bond issue. The nature of the security for, and the source of, the payment may be determined from the terms of the bond indenture or on the basis of an underlying arrangement. An underlying arrangement to provide security for, or the source of, the payment of the principal or interest on an obligation may result from separate agreements between the parties or may be determined on the basis of all the facts and circumstances surrounding the issuance of the bonds. The property which is the security for, or the source of, the payment of either the principal or interest on a debt obligation need not be property acquired with bond proceeds. The security interest test is satisfied if, for example, a debt obligation is secured by unimproved land or investment securities used, directly or indirectly, in any trade or business carried on by any private business user. A pledge of the full faith and credit of a State or local governmental unit will not prevent a debt obligation from otherwise satisfying the security interest test. For example, if the payment of either the principal or interest on a bond issue is secured by both a pledge of the full faith and credit of a State or local governmental unit and any interest in property used or to be used in a trade or business, the bond issue satisfies the security interest test. For rules with respect to the acquisition of the output of facilities, see subparagraph (5) of this paragraph.

(5) *Trade or business test and security interest test with respect to certain output contracts.* (i) The use by one or more nonexempt persons of a major portion of the subparagraph (5) output of facilities such as electric energy, gas, or water facilities constructed, reconstructed, or acquired with the proceeds of an issue satisfies the trade or business test and the security interest test if such use has the effect of transferring to nonexempt persons the benefits of ownership of such facilities, and the burdens of paying the debt service on governmental obligations used directly or indirectly to finance such facilities, so as to constitute the indirect use by them of a major portion of such proceeds. Such benefits and burdens are transferred and a major portion of the proceeds of an issue is used indirectly by the users of the sub-

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paragraph (5) output of such a facility which is owned and operated by an exempt person where—

(*a*)(*1*) One nonexempt person agrees pursuant to a contract to take, or to take or pay for, a major portion (more than 25 percent) of the subparagraph (5) output (within the meaning of subdivision (ii) of this subparagraph) of such a facility (whether or not conditional upon the production of such output) or (*2*) two or more nonexempt persons, each of which pays annually a guaranteed minimum payment exceeding 3 percent of the average annual debt service with respect to the obligations in question, agree, pursuant to contracts, to take, or to take or pay for, a major portion (more than 25 percent) of the subparagraph (5) output of such a facility (whether or not conditioned upon the production of such output), and

(*b*) Payment made or to be made with respect to such contract or contracts by such nonexempt person or persons exceeds a major part (more than 25 percent) of the total debt service with respect to such issue of obligations.

(ii) For purposes of this subparagraph—

(*a*) Where a contract described in subdivision (i) of this subparagraph may be extended by the issuer of obligations described therein, the term of the contract shall be considered to include the period for which such contract may be so extended.

(*b*) The subparagraph (5) output of a facility shall be determined by multiplying the number of units produced or to be produced by the facility in one year by the number of years in the contract term of the issue of obligations issued to provide such facility. The number of units produced or to be produced by a facility in one year shall be determined by reference to its nameplate capacity (or where there is no nameplate capacity, its maximum capacity) without any reduction for reserves or other unutilized capacity. The contract term of an issue begins on the date the output of a facility is first taken, pursuant to a take or a take or pay contract, by a nonexempt person and ends on the latest maturity date of any obligation of the issue (determined without regard to any optional redemption dates). If, however, on or before the date of issue of a prior issue of governmental obligations issued to provide a facility, the issuer makes a commitment in the bond indenture or related document to refinance such prior issue with one or more subsequent issues of governmental obligations, then the contract term of the issue shall be determined with regard to the latest redemption date of any obligation of the last such refinancing issue with respect to such facility (determined without regard to any optional redemption dates). Where it appears that the term of an issue (or the terms of 2 or more issues) is extended for purposes of extending the contract term of an issue and thereby increasing the subparagraph (5) output of the facility provided by such issue, the subparagraph (5) output of such facility shall be determined by the Commissioner without regard to the provisions of this subdivision (*b*).

(*c*) The total debt service with respect to an issue of obligations shall be the total dollar amount (excluding any penalties) payable with respect to such issue over its entire term. The entire term of an issue begins on its date of issue and ends on the latest maturity date of any obligation of the issue (determined without regard to any optional redemption

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[¶ 981]—Continued

dates). If, however, on or before the date of issue of a prior issue of governmental obligations the issuer makes a commitment in the bond indenture or related document to refinance such prior issue with one or more subsequent issues of governmental obligations, the entire term of the issue shall be determined with regard to the latest redemption date of any obligation of the last such refinancing issue (determined without regard to any optional redemption dates).

(*d*) Two or more nonexempt persons who are related persons (within the meaning of section 103(c)(6)(C)) shall be treated as one nonexempt person.

(c) *Examples.* The application of the rules contained in section 103(c)(2) and (3) and paragraph (b) of this section are illustrated by the following examples:

Example (1). State A and corporation X enter into an arrangement under which A is to provide a factory which X will lease for 20 years. The arrangement provides (1) that A will issue $10 million of bonds, (2) that the proceeds of the bond issue will be used to purchase land and to construct and equip a factory in accordance with X's specifications, (3) that X will rent the facility (land, factory, and equipment) for 20 years at an annual rental equal to the amount necessary to amortize the principal and pay the interest on the outstanding bonds, and (4) that such payments by X and the facility itself will be the security for the bonds. The bonds are industrial development bonds since they are part of an issue of obligations (1) all of the proceeds of which are to be used (by purchasing land and constructing and equipping the factory) in a trade or business by a nonexempt person, and (2) the payment of the principal and interest on which is secured by the facility and payments to be made with respect thereto.

Example (2). The facts are the same as in example (1) except that (1) X will purchase the facility, and (2) annual payments equal to the amount necessary to amortize the principal and pay the interest on the outstanding bonds will be made by X. The bonds are industrial development bonds for the reasons set forth in example (1).

Example (3). State B and corporation X enter into an arrangement under which B is to loan $10 million to X. The arrangement provides (1) that B will issue $10 million of bonds, (2) that the proceeds of the bond issue will be loaned to X to provide additional working capital and to finance the acquisition of certain new machinery, (3) that X will repay the loan in annual installments equal to the amount necessary to amortize the principal and pay the interest on the outstanding bonds, and (4) that the payments on the loan and the machinery will be the security for only the payment of the principal on the bonds. The bonds are industrial development bonds since they are part of an issue of obligations (1) all of the proceeds of which are to be used in a trade or business by a nonexempt person, and (2) the payment of the principal on which is secured by payments to be made in respect of property to be used in a trade or business. The result would be the same if only the payment of the interest on the bonds were secured by payments on the loan and machinery.

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sale, such as delivery, installation, alterations, modifications, and improvements; and (b) taxes to the extent imposed on a cash sale of the goods, services, or interest in land. The cash price stated by the seller to the buyer in a disclosure statement required by law is presumed to be the cash price.

(10) "Conspicuous":

A term or clause is "conspicuous" when it is so written that a reasonable person against whom it is to operate ought to have noticed it. Whether or not a term or clause is conspicuous is for decision by the court.

(11) "Consumer" means the buyer, lessee, or debtor to whom credit is granted in a consumer credit transaction.

(12) "Consumer credit sale":

(a) Except as provided in paragraph (b), "consumer credit sale" means a sale of goods, services, or an interest in land in which:

(i) credit is granted either pursuant to a seller credit card or by a seller who regularly engages as a seller in credit transactions of the same kind;

(ii) the buyer is a person other than an organization;

(iii) the goods, services, or interest in land are purchased primarily for a personal, family, household, or agricultural purpose;

(iv) the debt is payable in instalments or a finance charge is made; and

(v) with respect to a sale of goods or services, the amount financed does not exceed $25,000.

(b) A "consumer credit sale" does not include:

(i) a sale in which the seller allows the buyer to purchase goods or services pursuant to a lender credit card, or

(ii) unless the sale is made subject to this Act by agreement (Section 1.109), a sale of an interest in land if the finance charge does not exceed 12 per cent per year calculated according to the actuarial method on the assumption that the debt will be paid according to the agreed terms and will not be paid before the end of the agreed term.

(c) The amount of $25,000 in paragraph (a)(v) is subject to change pursuant to the provisions on adjustment of dollar amounts (Section 1.106).

(13) "Consumer credit transaction" means a consumer credit sale or consumer loan or a refinancing or consolidation thereof, or a consumer lease.

(14) "Consumer lease":

(a) "Consumer lease" means a lease of goods:

(i) which a lessor regularly engaged in the business of leasing makes to a person, except an organization, who takes under the lease primarily for a personal, family, household, or agricultural purpose;

(ii) in which the amount payable under the lease does not exceed $25,000;

(iii) which is for a term exceeding four months; and

(iv) which is not made pursuant to a lender credit card.

(b) The amount of $25,000 in paragraph (a)(ii) is subject to change pursuant to the provisions on adjustment of dollar amounts (Section 1.106).

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STATEMENT OF THE INVESTMENT COMPANY INSTITUTE

The Investment Company Institute [1] (the "Institute") offers the following comments and proposals regarding those provisions of H.R. 1800 and H.R. 2110 which affect mutual funds and their shareholders.

1. HOLDING PERIOD FOR LOSSES INCURRED WITH RESPECT TO TAX-EXEMPT MUTUAL FUNDS

Section 104(c) of H.R. 1800, as introduced, would amend Code section 852(b)(4)(B) to deny a shareholder's loss on the sale or exchange of stock in a regulated investment company ("RIC"), more commonly known as a mutual fund, to the extent that the shareholder has received exempt-interest dividends [2] on that stock if the shareholder has held the stock for less than six months. Under current law, such losses are disallowed only if the shareholder has held the stock for less than 31 days. The proposed extension of the holding period for RIC stock would make this holding period requirement consistent with the 6 months holding period requirement adopted in the Tax Reform Act of 1984 with respect to losses incurred following the payment of a long-term capital gain divided.

Presumably this proposal is based upon a belief that the current 31-day holding period is an insufficient deterrent to tax-motivated transactions by shareholders seeking to generate both tax-exempt income in the form of an exempt-interest dividend and short-term capital losses from the sale of the RIC stock when the stock declines in value upon going ex-dividend.

The Institute believes that the proposed extension of the holding period should not apply to those RICs whose share price never reflects any significant amount of tax-exempt interest previously earned by the fund prior to the taxpayer's purchase of the shares as, for example, in the case of a fund which declares dividends daily. The following example illustrates a fund which does not permit the abusive transaction sought to be prevented: Assume a RIC which declares exempt-interest dividends daily in an amount that substantially equals the exempt-interest earned by the RIC each day. Dividends are paid at the end of each month, but, because the dividends are declared daily, a shareholder is entitled to receive dividends only for those days during the month on which he held stock in the RIC. Thus, if the RIC stock is valued at $10.00 per share and the RIC pays dividends at the rate of 1% per month, a shareholder who held the stock for the entire month of June would receive a dividend of 10 cents on June 30. A taxpayer who acquired the stock on June 24 would receive only 2 cents per share on June 30. Moreover, the value of the stock on June 24 would not include any amount representing a right to receive income previously earned by the RIC, since purchasers of the stock on June 24 did not acquire any right to receive such amounts. Rather, interest earned by the RIC before June 24 would have already been declared on prior days as dividends receivable by those who were shareholders on those prior days and would have already reduced the price of the stock.

If the shareholder who acquired his stock on June 24 were to sell his stock on July 1, no change in the value of the RIC stock could be attributable to the payment of dividends by the RIC that included interest earned by the RIC prior to June 24. Thus, the tax-motivated transaction that the proposed 6-month rule seeks to discourage cannot occur in this case.

We believe that our proposed amendment to the holding period rule in section 104(c) of the bill would achieve the intended purpose of discouraging tax-motivated transactions in RIC shares without imposing an undue penalty on shareholders whose transactions in RIC stock are not tax-motivated. Such a penalty would be imposed, under the amendment contained in H.R. 1800, if the value of RIC shares declined as the result of an increase in interest rates and the shareholder could not deduct the loss because he had received exempt-interest dividends, even though the dividends had nothing to do with the decline in value of the RIC shares. The penalty results, in effect, from a presumption that any loss on a disposition of RIC shares is due to the receipt of exempt-interest dividends (up to an amount equal to the amount of such dividends) rather than some other cause, such as an increase in interest rates.

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[1] The Investment Company Institute is the national association of the American mutual fund industry. Its membership includes 1,140 open-end investment companies ("mutual funds"), their investment advisers and principal underwriters. Its mutual fund members have assets of about $345 billion, accounting for approximately 90% of total industry assets, and have approximately 20 million shareholders.

[2] Code section 852(b)(5) permits a qualifying mutual fund to pay an exempt-interest dividend to its shareholders if, at the close of each quarter of its taxable year, at least 50 percent of the total assets of the fund are invested in obligations exempt from tax under Code section 103(a). In fact, these funds have substantially all of their assets invested in tax-exempt obligations. Exempt-interest dividends are treated by the shareholders as interest excludable from income under section 103(a).

In lieu of section 104(c) of H.R. 1800, the Institute recommends the application of a six month holding period requirement except to the extent the Secretary provides in regulations for reduced holding period requirements for stock in RICs that regularly declare exempt-interest dividends in an amount that is not less than 90% nor more than 110% of the net tax-exempt income, i.e., tax-exempt interest net of expenses, it has earned during the period between each dividend declaration date. If a RIC satisfies these requirements, the required holding period is reduced to the number of days in the dividend declaration cycle. For example, if a RIC satisfies these requirements and declares dividends daily, the required holding period would be one day. With respect to RICs that satisfy these requirements and declare exempt-interest dividends monthly or quarterly, the required holding periods would be one month or three months, respectively.[3]

Attached as Appendix A are proposed statutory language and proposed language for the Committee Report relating to section 104(c) of H.R. 1800.

2. PERSONAL HOLDING COMPANY RECORDKEEPING REQUIREMENTS APPLICABLE TO RICS

Section 1071 of the Tax Reform Act of 1984 eliminated from the RIC qualification provisions the prohibition that a RIC could not be a personal holding company. Thus a RIC will not fail to qualify under Subchapter M solely by virtue of its status as a personal holding company, as defined in Code section 542. However, as amended by section 1071 of the Tax Reform Act, Code section 852(b) provides that a RIC which is a personal company shall be taxed at the highest corporate rate (currently 46 percent) with respect to any undistributed earnings.

In general, this change in the law reflects the belief that a RIC should not suffer the disastrous consequences of failing to qualify under Subchapter M solely by virtue of falling within the definition of a personal holding company. Rather, a more appropriate penalty, based on an undistributed earnings tax, was substituted in Subchapter M for RICs which may also be classified as personal holding companies.

Consistent with this policy and the 1984 Tax Reform Act's revisions of Subchapter M to delete the personal holding company prohibition, the Institute urges the repeal of Code section 852(a)(2). That provision of the Code states that a RIC may not qualify under Subchapter M unless, for each of its taxable years, the RIC complies with the Treasury regulations relating to ascertaining the actual ownership of the outstanding shares of stock of the RIC. As this provision was intended to assist the Secretary of the Treasury in determining whether a RIC was a personal holding company and, therefore, disqualified under Subchapter M, its original intent is no longer relevant. Moreover, its presence as a qualification requirement under Subchapter M is unduly harsh. Since a RIC is not disqualified under Subchapter M if it happens to be a personal holding company, a RIC which fails to fully comply with the regulations designed to determine personal holding company status should similarly not be disqualified under Subchapter M.

Although the Institute recommends deletion of this recordkeeping provision from the qualification tests of Subchapter M, we recognize that the status of a RIC as a personal holding company may still have some significance under amended section 852(b). Since, as mentioned above, a RIC which is also a personal holding will be taxed pursuant to section 852(b) at the highest corporate rate on undistributed earnings, it is not inappropriate for the Secretary of the Treasury to require that RICs obtain information relating to the actual ownership of the RIC's outstanding stock so that the Treasury can determine whether a RIC is in fact a personal holding company. However, since the 1984 Tax Reform Act changed the consequences of per-

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[3] With respect to RICs that declare dividends monthly or quarterly, it is possible for a taxpayer to purchase stock that includes the right to receive (as a dividend) interest earned by the RIC during the period between the immediately preceding dividend declaration date and the date the taxpayer acquired the RIC stock. However, since, under our proposal, the taxpayer must hold the stock through a complete dividend declaration cycle, he will not be able to sell the stock and recognize a loss before there is a similar "build-up" of interest increasing the value of the stock. For example, if a taxpayer acquires stocks of a RIC on August 15 and the RIC declares and pays dividends monthly on the last day of each month, the value of the RIC stock when purchased on August 15 will include interest earned by the RIC from August 1 through August 14. However, under our proposal, the taxpayer cannot sell the stock (without being subject to the loss disallowance rule) until September 15, and by that date there will be a "build-up" of earned but undistributed interest with respect to the stock just as there was on August 15 when the taxpayer purchased the stock. If the taxpayer sells the stock at that point, the interest that had "built-up" before he bought the stock should be at least roughly offset by the similar build-up of interest in the stock at the time he sold it.

sonal holding company status from disqualification under Subchapter M to the imposition of the maximum corporate tax on undistributed income, the Institute believes that the consequences of failing to comply with regulations proposed to assist the Treasury in determining personal holding company status should be modified in the same manner.

Accordingly, the Institute recommends that the requirements of Code section 852(a)(2) be moved to Code section 852(b)(1) so that a RIC which either meets the definition of a personal holding company or fails to comply with the Secretary's regulations relating to ascertaining the actual ownership of the RIC's outstanding stock would be taxed on any undistributed investment company taxable income at the highest corporate rate. Proposed statutory language to accomplish this change is attached hereto as Appendix B.

3. PROPOSED AMENDMENT RELATING TO CODE SECTION 103(h)

As amended in the Tax Reform Act of 1984, Code section 103(h) denies tax-exempt status to the interest on municipal obligations the repayment of which is directly or indirectly guaranteed by the United States government or any agency or instrumentality thereof. Specifically, 103(h) denies tax exemption to an obligation if: (1) the payment of principal or interest on the obligation is directly or indirectly guaranteed (in whole or in part) by the United States or an agency or instrumentality thereof, or (2) the obligation is issued as part of an issue and a significant portion of the proceeds of the issue are invested directly or indirectly in federally insured deposits or accounts.

Two recent federal court decisions, *Philadelphia Gear Corporation* v. *Federal Deposit Insurance Corporation*,—F. 2d—(Nos. 84-1901, 84-2007 (10th Cir., 1984)) and *Allen et al.* v. *Federal Deposit Insurance Corporation*,—F. Supp.—No. Civ. 3-84-274 (E.D. Tenn. Oct. 24, 1984) have given a new significance to these provisions of section 103(h). These cases have held that a standby letter of credit issued by a bank insured by the Federal Deposit Insurance Corporation ("FDIC") constitutes an FDIC-insured "deposit" within the meaning of the Federal Deposit Insurance Act, 12 U.S.C. section 1811 et seq. Thus, questions have been raised as to whether the interest on certain municipal obligations secured by a letter of credit from an FDIC-insured bank would be denied exemption from federal income tax under Code section 103(h).

The immediacy of this problem has been temporarily postponed by an IRS Release (See IR-85-42, dated April 26, 1985), which grandfathers the tax-exempt status of obligations backed by letters of credit of FDIC-insured banks and issued before December 31, 1985. However, the Institute, on behalf of its municipal bond fund members, believes that permanent legislative relief is necessary to clarify the status of these letters of credit-backed obligations issued after December 31, 1985.

The Institute suggests that the conditions for denying tax exemption under Code section 103(h) should be clarified to apply in only those instances where a municipal obligation was marketed and purchased in reliance upon the existence of a federal guarantee. In the case of a mutual fund designed to invest in tax-exempt obligations,[4] the fund does not rely upon the possible availability of $100,000 of FDIC insurance coverage with respect to one or more of the obligations in its portfolio. Such obligations are not typically rated or marketed to mutual funds on the basis of the possible existence of federal deposit insurance. Therefore, tax-exempt obligations held by mutual funds should not fall within the definition of a "federally guaranteed" obligations under Code section 103(h). The scope of the definition of "federally guaranteed" obligations should be narrowed to reflect only the abusive situations intended to be cured by the Tax Reform Act, not others which may be covered as a result of the recent judicial decisions mentioned above. We would be pleased to work with the Committee or its staff to develop appropriate legislative language to accomplish this result.

4. DIVERSIFICATION REQUIREMENTS APPLICABLE TO VARIABLE ANNUITY CONTRACTS—CODE SECTION 817(h)

The Tax Reform Act of 1984 amended Code section 817 to provide diversification requirements applicable to variable insurance contracts. In general these provisions state that, the Secretary of the Treasury may prescribe diversification requirements applicable to variable contracts; however, the statute itself also provides a diversifi-

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[4] At the present time, Institute statistics indicate that municipal bond funds hold approximately $60 billion worth of obligations exempt from tax under Code section 103(a).

cation safe harbor. Pursuant to the statutory safe harbor, a variable annuity contract will be treated as adequately diversified if it meets the diversification requirements applicable to RICs under Code section 851(b)(4) and the fund has no more than 55 percent of its assets invested in cash, cash items, government securities and securities of other RICs.

The safe harbor specifically permits a variable annuity contract which is based upon a fund, 55 percent of which may be invested in the stock of another RIC, including, presumably, a RIC whose shares are available for sale to the public. Unfortunately, this measure, intended to permit the marketing of a variable annuity funded in part with RIC stock whose shares are available for sale to the public, has had no impact. The safe harbor provision is entirely impractical and unworkable. To our knowledge no variable annuity product in existence today is based up a fund owning a significant percentage of shares of another RIC which is offered to the public.

The Institute believes that the diversification safe harbor provision included in the 1984 Tax Reform Act should be clarified to permit a variable annuity to be fully funded through a mutual fund, the shares of which are available for sale to the public. Absent such a provision, current law creates a discrimination within the mutual fund industry between mutual fund sponsors affiliated with life insurance companies and those which are not. Mutual funds affiliated with insurance companies may sponsor the dedicated funds upon which variable products must currently be based. However, mutual funds not affiliated with an insurance company may not, as a practical matter, join with an unaffiliated life insurance company to offer a variable annuity product.

The reasons for distinguishing between variable annuities funded through a dedicated mutual fund and those based upon funds whose shares are available for sale to the public no longer exist. Both mutual funds available to the public and those dedicated funds currently serving as the basis of variable annuity contracts are subject to the requirements of the Investment Company Act of 1940. Moreover, with the enactment of TEFRA and the Tax Reform Act of 1984, significant further restrictions have been placed on deferred annuities. There is no further need for additional tax law provisions differentiating between direct investment and long-term investment through annuities.

With the tax law concerns distinguishing between annuities and direct investment incorporated into law, Congress should correct the unwarranted discrimination within the mutual fund industry between mutual funds affiliated with insurance companies and those which are not. The diversification safe harbor set forth in Code section 817 pursuant to the Tax Reform Act should be expanded to permit a mutual fund whose shares are available for sale to the public to fully fund a variable insurance contract rather than permitting only 55 percent of the underlying funding vehicle to include shares of a publicly-offered mutual fund. The proposed amendment to Code Section 817 which is set forth in Appendix C would correct and clarify the safe harbor provision of that section by permitting the use of a publicly-offered mutual fund as the funding vehicle for variable insurance products.

5. H.R. 2110 TECHNICAL CORRECTIONS TO THE RETIREMENT EQUITY ACT—THE REQUIREMENT TO PURCHASE A COMMERCIAL ANNUITY

It has recently come to the Institute's attention that the Internal Revenue Service ("IRS") may be interpreting the joint and survivor and preretirement survivor annuity requirements of Code sections 401(a)(11) and 417, as amended by the Retirement Equity Act, in a manner that would require that certain defined contribution retirement plans provide for the purchase of commercial annuity. The Institute believes that such an interpretation is not justified under either the specific language or intent of the Retirement Equity Act and that statutory or Committee Report language clarifying this point are highly desirable.

As revised by the Retirement Equity Act, section 401(a)(11) of the Code requires that certain defined contributions plans [5] provide benefits in the form of a "qualified joint and Survivor annuity" and also provides death benefits in the form of a "qualified preretirement survivor annuity". Both of these forms of benefits are described in Code section 417.

Section 417(b) of the Code defines a "qualified joint and survivor annuity" as:

". . . an annuity—

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[5] This requirement extends to essentially all defined contribution retirement plans other than those profit-sharing plans which automatically provide for the participant's accrued, vested benefit to be paid to his or her surviving spouse in the event of death.

(1) for the life of the participant with a survivor annuity for the life of the spouse which is not less than 50 percent of (and is not greater than 100 percent of) the amount of the annuity which is payable during the joint lives of the participant and spouse, and

(2) which is the actuarial equivalent of a single annuity for the life of the participant.

Such term also includes any annuity in a form having the effect of an annuity described in the preceding sentence." [Emphasis added.]

Section 417(c)(2) of the Code defines a "qualified preretirement survivor annuity" for a defined contribution plan as, "an annuity for the life of the surviving spouse the actuarial equivalent of which is no less than 50 percent of the account balance of the participant as of the date of death."

Prior to the revision of the joint and survivor rules by the Retirement Equity Act of 1984, most defined contribution plans satisfied the joint and survivor rules without having to offer the purchase of an annuity contract. This was accomplished by paying out the participant's account balance upon death after the participant attained early retirement age.

Although we recognize that the recent changes to the joint and survivor rules reflect an intent to require defined contribution pension plans to provide greater protection for participants' spouses than was previously required, we believe that this protection can be accomplished without the purchase of a commercial annuity contract from an insurance company. Moreover, we believe that statutory language cited above, specifically permits plans to provide the required joint and survivor protection through means that would not contravene a participant's chosen investment medium.

However, in light of a recent IRS interpretation of these requirements [6] Institute recommends that the Retirement Equity Act be clarified. Specifically, we urge the adoption of either statutory or Committee Report language providing that an annuity from a defined contribution plan will be considered a "qualified joint and survivor annuity" if it meets the following requirement: the payment in any year does not exceed the value of the account balance at the beginning of that year divided by the joint and last survivor life expectancy of the participant and spouse, based on the ages of those individuals at the beginning of that year.

Similarly, we propose that the Retirement Equity Act be revised to clearly indicate that an annuity from a defined contribution plan will be considered a "qualified preretirement survivor annuity" if it meets the following requirements: at least 50 percent of the participant's account balance at death is used to provide an annuity to the spouse; and the payment in any year does not exceed the remaining death benefit at the beginning of that year divided by the spouse's life expectancy, based on the spouse's age at the beginning of the year.

The joint and survivor rules were enacted to provide extra protection to the spouses of plan participants in their retirement years. This assurance of retirement income can be adequately provided under our proposal, without the purchase of a commercial annuity contract.

Attached hereto as Appendix D are three exhibits which we believe demonstrate the adequacy of the survivor's benefits that would be provided under the Institute's proposal. Tables 1, 2, and 3 show the annual distribution that would be made under our proposal to a participant who retires at age 65 with a spouse who is five years younger. The tables assume a fund with an annual return of 3 percent, 5 percent, and 7 percent, respectively.[7] Note that, regardless of the funds' earnings, the payments continue at a significant level for many years. Assuming a 5 percent fund annual return, the annual payment will not drop under 50 percent of the initial payment until the spouse has attained age 102. Furthermore, the payment in year 36 exceeds the amount paid in the first year.

Reviewing these projections, we believe that our proposal is consistent with the policy objective of providing significant protection for participants' spouses. Similar patterns would result in the case of the preretirement survivor annuity. In that

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[6] IRS LRMs (model language) issued for use in master and prototype plans have required that certain defined contributions plans provide for the purchase of a commercial annuity to satisfy the joint and survivor and preretirement survivor annuity definitions.

[7] From 1979 to the present, the average annual return on money market funds has ranged between a low of 8.58 percent and a high of 16.82 percent. (From *Donoghue's Money Fund Report.)* For the past ten years common stock mutual funds have performed at an average annual rate of about 15 percent, and for the past twenty-five years common stock funds have performed at an average annual rate of about 9.2 percent.

case, however, there should even be less concern, because the spouse will not be "sharing" the distribution with any other beneficiaries.

In addition, an interpretation of the provisions of the Retirement Equity Act which would require that plans provide for the purchase of a commercial annuity represents a governmental intrusion into the marketplace which would have an unfair competitive effect on the mutual fund industry. If certain defined contribution plans invested in mutual funds are required to offer benefits in the form of an insurance company annuity contract, significant amounts will have to be withdrawn from mutual funds for the purchase of annuity contracts. Plan participants would be denied the opportunity to fund their retirement plan through their preferred investment medium.

For these reasons, the Institute urges the adoption of the proposal set forth above to clarify the joint and survivor and preretirement survivor annuity requirements of the Retirement Equity Act.

The Institute appreciates the opportunity to present these comments to the Committee. Please contact us if you have any questions regarding these proposals.

APPENDIX A

PROPOSED STATUTORY LANGUAGE

Sections 104(c)(1) and (2) of the Technical Corrections Act are amended to read as follows:

(c) AMENDMENTS RELATED TO SECTION 55 OF THE ACT (C)(1).—

(1) Clause (ii) of section 852(b)(4)(B) (relating to losses attributable to exempt-interest dividend) is amended by striking out "for less than 31 days" and inserting in lieu thereof "for 6 months or less *(or for such lesser period as the Secretary may prescribe by regulation for shares of regulated investment companies that regularly distribute substantially all of their exempt-interest income).*"

(2) Subparagraph (C) of Section 852(b)(4) (relating to determining of holding periods) is amended to read as follows:

"(C) DETERMINATION OF HOLDING PERIODS.—For purposes of this paragraph, the rules of paragraphs (3) and (4) of Section 24(c) shall apply in determining the period for which the taxpayer has held any share of stock; except that '6 months' *(or, if applicable, the period determined under regulations issued pursuant to subparagraph (B) of this paragraph)* shall be substituted for each number of days specified in subparagraph (B) of Section 246(c)(3)."

LANGUAGE TO BE INCLUDED IN COMMITTEE REPORT

"It is intended that the regulations to be issued by the Secretary will provide a sufficient deterrent to tax-motivated transactions in RIC stock while at the same time avoiding undue penalties with respect to other transactions in RIC stock. Since the abuse sought to be prevented is dependent upon changes in the value of RIC stock resulting from the payment of exempt-interest dividends that include interest earned by a RIC prior to the time the taxpayer acquired the RIC stock, the regulations should provide for reduced holding periods where the distribution practices of the RIC are such that the purposes of this provision can be adequately fulfilled without requiring that the stock be held for 6 months.

"Therefore in the case of a RIC which regularly declares exempt-interest dividends in an amount substantially equivalent to the tax-exempt interest it has earned during the period between each dividend declaration date, the required holding period should be reduced to the number of days in the dividend declaration cycle. The 'substantially equivalent' requirement will be satisfied if the RIC distributes not less than 90 percent, and not more than 110 percent, of the next tax-exempt income it has earned during such period. Thus, for example, if a fund declares dividends daily in an amount that is not less than 90 percent nor more than 110 percent of the net tax-exempt income earned by the fund during each day, the requisite holding period would be one day. Similarly, if a RIC declares dividends monthly, and satisfies the "substantially equivalent" standard, the requisite holding period would be one month. Shareholders of a RIC that does not satisfy these requirements will be subject to the 6-month holding period rule."

APPENDIX B

Code section 852(a) is amended by striking out paragraph (2); by striking out the comma at the end of paragraph (1) and inserting in lieu thereof "and,"; and by redesignating paragraph (3) as paragraph (2).

Paragraph (1) of Code section 852(b) is amended by striking out the second sentence and inserting the following new sentence in lieu thereof: "In the case of a regulated investment company—

(A) which is a personal holding company (as defined in section 542) or

(B) which fails to comply for such taxable year with regulations prescribed by the Secretary for the purpose of ascertaining the actual ownership of its outstanding stock,

that tax shall be computed at the highest rate of tax specified in section 11(b)."

APPENDIX C

Code section 817 shall be amended by adding thereto a new section 817(i) as follows:

"(i) TREATMENT OF VARIABLE ANNUITY AND VARIABLE LIFE CONTRACTS UNDER SECTION 61.—If a variable contract described in this section has a beneficial interest in a segregated asset account holding shares of one or more regulated investment companies (whether directly or through a unit investment trust), the treatment of such contracts under section 61 (defining gross income) and this section (relating to variable contracts) shall be determined without regard to whether such shares are available for purchase by persons other than such segregated asset accounts. For purposes of subsection (h) of this section, a segregated asset account shall not be treated as non-diversified solely on account of its ownership of beneficial interests of a regulated investment company whose shares are available for purchase by the public."

APPENDIX D

TABLES 1, 2, AND 3

Projects annual payments from a fund based on Institute proposals

Assumptions:

Payments commence when male participant retires at age 65 with female spouse, age 60.

One payment each year at beginning of year.

Joint and last survivor life expectancies based on Table II of 1.72-9 as adjusted for annual payments in accordance with 1.72-5(a)(2).

Fund with an annual rate of return at 3 percent, 5 percent, or 7 percent annually.

MINIMUM DISTRIBUTIONS FOR LUMP SUM PRESENT VALUES

INTEREST RATE: 7.00%

MALE AGE(x)	FEMALE AGE(x)	PRESENT VALUE	J & S LIFE EXPECTANCY	ANNUAL PAYMENT	PV AFTER DISTRIBUTION
65	60	$100,000	25.1	$3,984	$96,016
66	61	$102,737	24.3	$4,228	$98,509
67	62	$105,405	23.5	$4,485	$100,920
68	63	$107,984	22.7	$4,757	$103,227
69	64	$110,453	22.0	$5,021	$105,432
70	65	$112,812	21.2	$5,321	$107,491
71	66	$115,015	20.5	$5,611	$109,405
72	67	$117,063	19.7	$5,942	$111,121
73	68	$118,899	19.0	$6,258	$112,642
74	69	$120,527	18.3	$6,586	$113,940
75	70	$121,916	17.6	$6,927	$114,989
76	71	$123,038	16.9	$7,280	$115,758
77	72	$123,861	16.3	$7,599	$116,262
78	73	$124,401	15.6	$7,974	$116,426
79	74	$124,576	15.0	$8,305	$116,271
80	75	$124,410	14.4	$8,640	$115,770
81	76	$123,874	13.6	$9,108	$114,766
82	77	$122,799	13.2	$9,303	$113,496
83	78	$121,441	12.6	$9,638	$111,803
84	79	$119,629	12.1	$9,887	$109,743
85	80	$117,425	11.5	$10,211	$107,214
86	81	$114,719	11.0	$10,429	$104,290
87	82	$111,590	10.5	$10,628	$100,962
88	83	$108,030	10.0	$10,803	$97,227
89	84	$104,033	9.6	$10,837	$93,196
90	85	$99,720	9.1	$10,958	$88,761
91	86	$94,975	8.7	$10,917	$84,058
92	87	$89,942	8.3	$10,836	$79,106
93	88	$84,643	7.9	$10,714	$73,929
94	89	$79,104	7.5	$10,547	$68,557
95	90	$73,356	7.2	$10,188	$63,167
96	91	$67,589	6.9	$9,796	$57,794
97	92	$61,839	6.6	$9,370	$52,470
98	93	$56,142	6.3	$8,911	$47,231
99	94	$50,537	6.0	$8,423	$42,114
100	95	$45,062	5.7	$7,906	$37,157
101	96	$39,758	5.4	$7,363	$32,395
102	97	$34,663	5.1	$6,797	$27,866
103	98	$29,817	4.8	$6,212	$23,605
104	99	$25,257	4.5	$5,613	$19,645
105	100	$21,020	4.2	$5,005	$16,015
106	101	$17,136	3.9	$4,394	$12,742
107	102	$13,634	3.6	$3,787	$9,847
108	103	$10,536	3.3	$3,193	$7,343
109	104	$7,857	3.0	$2,619	$5,238
110	105	$5,605	2.7	$2,076	$3,529
111	106	$3,776	2.4	$1,573	$2,203
112	107	$2,357	2.1	$1,122	$1,235

MINIMUM DISTRIBUTIONS FOR LUMP SUM PRESENT VALUES

INTEREST RATE: 5.00%

MALE AGE(x)	FEMALE AGE(x)	PRESENT VALUE	J & S LIFE EXPECTANCY	ANNUAL PAYMENT	PV AFTER DISTRIBUTION
65	60	$100,000	25.1	$3,984	$96,016
66	61	$100,817	24.3	$4,149	$96,668
67	62	$101,501	23.5	$4,319	$97,182
68	63	$102,041	22.7	$4,495	$97,546
69	64	$102,423	22.0	$4,656	$97,768
70	65	$102,656	21.2	$4,842	$97,814
71	66	$102,704	20.5	$5,010	$97,695
72	67	$102,579	19.7	$5,207	$97,372
73	68	$102,241	19.0	$5,381	$96,860
74	69	$101,703	18.3	$5,558	$96,145
75	70	$100,952	17.6	$5,736	$95,216
76	71	$99,977	16.9	$5,916	$94,061
77	72	$98,765	16.3	$6,059	$92,705
78	73	$97,341	15.6	$6,240	$91,101
79	74	$95,656	15.0	$6,377	$89,279
80	75	$93,743	14.4	$6,510	$87,233
81	76	$91,595	13.6	$6,735	$84,860
82	77	$89,103	13.2	$6,750	$82,352
83	78	$86,470	12.6	$6,863	$79,607
84	79	$83,588	12.1	$6,908	$76,680
85	80	$80,514	11.5	$7,001	$73,512
86	81	$77,188	11.0	$7,017	$70,171
87	82	$73,679	10.5	$7,017	$66,662
88	83	$69,996	10.0	$7,000	$62,996
89	84	$66,146	9.6	$6,890	$59,256
90	85	$62,218	9.1	$6,837	$55,381
91	86	$58,150	8.7	$6,684	$51,466
92	87	$54,040	8.3	$6,511	$47,529
93	88	$49,905	7.9	$6,317	$43,588
94	89	$45,768	7.5	$6,102	$39,665
95	90	$41,648	7.2	$5,785	$35,864
96	91	$37,657	6.9	$5,458	$32,200
97	92	$33,810	6.6	$5,123	$28,687
98	93	$30,121	6.3	$4,781	$25,340
99	94	$26,607	6.0	$4,435	$22,173
100	95	$23,281	5.7	$4,084	$19,197
101	96	$20,157	5.4	$3,733	$16,424
102	97	$17,245	5.1	$3,381	$13,864
103	98	$14,557	4.8	$3,033	$11,524
104	99	$12,100	4.5	$2,689	$9,411
105	100	$9,882	4.2	$2,353	$7,529
106	101	$7,906	3.9	$2,027	$5,879
107	102	$6,172	3.6	$1,715	$4,458
108	103	$4,681	3.3	$1,418	$3,262
109	104	$3,425	3.0	$1,142	$2,284
110	105	$2,398	2.7	$888	$1,510
111	106	$1,585	2.4	$661	$925
112	107	$971	2.1	$462	$509

MINIMUM DISTRIBUTIONS FOR LUMP SUM PRESENT VALUES

INTEREST RATE: 3.00%

MALE AGE(x)	FEMALE AGE(x)	PRESENT VALUE	J & S LIFE EXPECTANCY	ANNUAL PAYMENT	PV AFTER DISTRIBUTION
65	60	$100,000	25.1	$3,984	$96,016
66	61	$98,896	24.3	$4,070	$94,827
67	62	$97,671	23.5	$4,156	$93,515
68	63	$96,321	22.7	$4,243	$92,077
69	64	$94,840	22.0	$4,311	$90,529
70	65	$93,245	21.2	$4,398	$88,846
71	66	$91,512	20.5	$4,464	$87,048
72	67	$89,659	19.7	$4,551	$85,108
73	68	$87,661	19.0	$4,614	$83,047
74	69	$85,539	18.3	$4,674	$80,865
75	70	$83,291	17.6	$4,732	$78,558
76	71	$80,915	16.9	$4,788	$76,127
77	72	$78,411	16.3	$4,810	$73,600
78	73	$75,808	15.6	$4,860	$70,949
79	74	$73,077	15.0	$4,872	$68,205
80	75	$70,252	14.4	$4,879	$65,373
81	76	$67,334	13.6	$4,951	$62,383
82	77	$64,255	13.2	$4,868	$59,387
83	78	$61,169	12.6	$4,855	$56,314
84	79	$58,003	12.1	$4,794	$53,210
85	80	$54,806	11.5	$4,766	$50,040
86	81	$51,541	11.0	$4,686	$46,856
87	82	$48,262	10.5	$4,596	$43,665
88	83	$44,975	10.0	$4,498	$40,478
89	84	$41,692	9.6	$4,343	$37,349
90	85	$38,470	9.1	$4,227	$34,242
91	86	$35,269	8.7	$4,054	$31,215
92	87	$32,152	8.3	$3,874	$28,278
93	88	$29,126	7.9	$3,687	$25,440
94	89	$26,203	7.5	$3,494	$22,709
95	90	$23,390	7.2	$3,249	$20,142
96	91	$20,746	6.9	$3,007	$17,739
97	92	$18,271	6.6	$2,768	$15,503
98	93	$15,968	6.3	$2,535	$13,434
99	94	$13,837	6.0	$2,306	$11,530
100	95	$11,876	5.7	$2,084	$9,793
101	96	$10,087	5.4	$1,868	$8,219
102	97	$8,465	5.1	$1,660	$6,805
103	98	$7,010	4.8	$1,460	$5,549
104	99	$5,716	4.5	$1,270	$4,446
105	100	$4,579	4.2	$1,090	$3,489
106	101	$3,593	3.9	$921	$2,672
107	102	$2,752	3.6	$764	$1,988
108	103	$2,047	3.3	$620	$1,427
109	104	$1,470	3.0	$490	$980
110	105	$1,009	2.7	$374	$635
111	106	$654	2.4	$273	$382
112	107	$393	2.1	$187	$206

IVINS, PHILLIPS & BARKER,
Washington, DC, May 30, 1985.

Re H.R. 1800 Technical Corrections Act of 1985.

JOSEPH K. DOWLEY,
Chief Counsel, Committee on Ways and Means, House of Representatives, Washington, DC.

DEAR SIR: Enclosed are six copies of a letter to members of the staffs of the Joint Committee on Taxation and Treasury's Tax Legislative Counsel's Office regarding a necessary technical correction to § 7872. We would appreciate your including this letter as part of the printed record of the hearing on H.R. 1800 held on May 16, 1985.

This firm represents the Employee Relocation Council (ERC), a trade association of over 1,000 major companies which, on a regular basis, must address the problems of employee relocation. We worked closely with the staffs of the Joint Committee and Treasury's Tax Legislative Counsel's Office during the consideration of § 7872 last summer. We believe that the correction highlighted in the attached letter was simply a drafting error and raises no policy considerations.

Sincerely yours,

PHILIP D. MORRISON.

IVINS, PHILLIPS & BARKER,
Washington, DC, April 10, 1985.

Re Technical corrections—Section 7872.

MELVIN C. THOMAS, Esq.,
Joint Committee on Taxation, Washington, DC,

FAIRLEA A. SHEEHY, Esq.,
Department of Treasury, Washington, DC.

DEAR MEL AND FAIRLEA: I was pleased to see in the proposed "Technical Corrections Act of 1985" (H.R. 1800 and S. 814) the technical amendments making it clear that there is to be no wage withholding under Chapter 24 with respect to either demand or term loans under § 7872 as well as the broadening of regulatory authority to provide that any loan with an indefinite maturity may be treated as a demand loan. One technical correction that I expected to see, however, was not included.

As you may recall, the statute requires that, for a loan to be treated as a deemed demand loan, the loan must be nontransferable and the interest rate benefit must be conditioned on the future performance of substantial services by an individual.[1] The legislative history, however, stated that the interest rate benefit only was to be subject to these two conditions.[2] The Joint Committee's "Bluebook" points out this discrepancy, reiterates Congress's intent that the employee's interest rate benefit, rather than the entire loan, must be nontransferable, and states that a technical amendment may be necessary to effectuate this intent.[3]

It seems a fairly simple matter to amend the second sentence of § 7872(f)(5) to effectuate Congress's clear intent. I would suggest the following: "Such term also includes (for purposes other than determining the applicable federal rate under paragraph (2)) any loan the benefits of the interest arrangements of which are not

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[1] Internal Revenue Code § 7872(f)(5):

"(5) DEMAND LOAN.—The term 'demand loan' means any loan which is payable in full at any time on the demand of the lender. Such term also includes (for purposes other than determining the applicable Federal rate under paragraph (2)) any loan which is not transferable and the benefits of the interest arrangements of which is conditioned on the future performance of substantial services by an individual."

[2] Statement of Managers, Conference Report for Deficit Reduction Act of 1984, H.R.Rpt. 98-861 (June 23, 1984), at page 1018: "For purposes of determining the timing and amount of the transfers deemed made under the provisions, a compensation related term loan is treated as a demand loan if the benefit derived by the employee from the interest arrangement is (1) nontransferable and (2) conditioned upon the future performance of substantial services by the employee."

[3] General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 (JCS-41-84, December 31, 1984), at pages 533-534: "The Congress intended that a loan be treated as nontransferable if the benefit derived by the employee from the interest arrangement cannot be transferred by the employee. A technical amendment may be necessary to effectuate this intent."

transferable and are conditioned on the future performance of substantial services by an individual."

This seems to me a simpler and far less confusing means for solving the problem than leaving it to regulations to adopt a non-common-sensical definition of what it means for a loan to be nontransferable. While the Treasury may have the authority to declare in regulations that a loan would be treated as non-transferable if the benefit derived by the employee in the interest arrangement cannot be transferred, a technical correction to the statute itself seems the far more direct and clear route.

This change is of some importance to Employee Relocation Council members since some employer-provided, relocation mortgage loans may be assumable. Under the statute as presently drafted, an assumable mortgage loan could not, of course, qualify as a deemed demand loan. With the proposed change, however, an assumable term loan could be deemed a demand loan provided that the below-AFR interest rate were not itself assumable.

If you have any questions about this matter or disagree with my conclusion that a technical correction is warranted, I would greatly appreciate a call.

Sincerely,

PHILIP D. MORRISON.

KENNETH LEVENTHALL & CO.,
Washington, DC, June 10, 1985.

Re H.R. 1800—Technical Corrections Act of 1985.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means, House of Representatives, Washington, DC.

DEAR MR. CHAIRMAN: The purpose of this letter is to request the inclusion, in H.R. 1800, of a technical amendment which would conform the statutory language of section 467(b)(1)(B) of the Internal Revenue Code to an explanatory statement that was contained in the Conference Committee report on the Deficit Reduction Act of 1984 ("the 1984 Act").

Section 467(b)(1)(B) applies to rent which, although not required to be levelled, is scheduled to increase over the term of a lease and is to be paid "after the close" of the taxable year to which it relates. The statute requires the Treasury to issue regulations that will discount, in accordance with present value concepts, the amounts to be taken into account under such an agreement as rental income and deduction by the lessor and lessee for the taxable year. In explaining this provision, the Conference Committee report on the 1984 Act stated (at page 892) that such discounting would be required in situations where the deferred amounts are not to be paid "until more than one year after the year to which they relate" (emphasis added). This explanation essentially brought the new provision into line with the de minimis imputed interest exceptions that are allowed when there is no more than a one year deferral of payment on the sale of property which is subject to the provisions of sections 483 and 1274.

In its General Explanation of the 1984 Act (at pages 287–288), the Joint Committee on Taxation followed the specific language of section 467(b)(1)(B) and stated that the discount provisions would apply to amounts that "are not payable by the close of" the period to which they relate. Although the General Explanation does not constitute a committee report, its inclusion of a statement which conflicts with the Conference Committee report causes uncertainty as to the manner in which the provision currently should be interpreted. Additionally, it would appear that the Joint Committee's interpretation, if sustained, would accomplish little more than creating a burden for taxpayers, with virtually no revenue gain to the government.

Subjecting taxpayers to this kind of uncertainty and complexity in dealing with the new law is not only unnecessary, it is inconsistent with the de minimis exclusions which have been provided historically for other imputed interest transactions. Accordingly, it is respectfully requested that there be included in H.R. 1800, a technical amendment giving effect to the explanatory statement that was contained in the Conference Committee report.

If you have any questions concerning the above, please call me at 775–1880.

Very truly yours,

ALAN D. LEWIS.

KNIGHTS OF COLUMBUS,
OFFICE OF TAX COUNSEL,
Washington, DC, June 10, 1985.

Re Section 128 of the Technical Amendments Act of 1985: Nonrecognition of insurance policy exchanges.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means, House of Representatives, Washington, DC.

DEAR MR. CHAIRMAN: This office serves as tax counsel to the Knights of Columbus of New Haven, Connecticut, a fraternal benefit society described in Section 501(c)(8) of the Internal Revenue Code of 1954, as amended. The Knights of Columbus is an international society of Catholic men, dedicated to strong family values, enhancement of our Church, and such ideals as charity, unity, fraternity and patriotism. Its benefit program gives over 1.3 million members in the United States the opportunity to purchase for themselves (or their wives or dependents), individual life, sick of accident policies from a society dedicated to his needs and values.

In Illinois, we have more than 300 councils and almost 75,000 members. On its behalf, we are requesting clarification of Section 128 of H.R. 1800, the Technical Corrections Act of 1985 to affirmatively provide nonrecognition of gain treatment under Code Section 1035 for exchanges made by policyholders of insurance issued by fraternal organizations.

This clarification would fulfill the 1984 intent of Congress for nonrecognition treatment of all types of policy exchanges based on the type of policy issued rather than the issuing company's taxable or tax-exempt status. Policies of fraternal benefit societies and similar 501(c) insurance organizations should be explicitly mentioned in the Code, or in the Committee Reports, as specifically eligible for Section 1035 nonrecognition. Because these organizations are not technically "insurance companies", our members holding benefit contracts are uncertain as to the tax treatment which will be given their policy exchanges. To remove the current ambiguities, we urge you to add a simple statement treating Section 501(c)(8) or other benefit plan organizations as qualifying for purposes of Section 1035(b)(1) of the Code.

A. CURRENT LAW UNDER I.R.C. SECTION 1035

Section 1035 was enacted in 1954 as part of the Internal Revenue Code's general revision, to allow a taxpayer to exchange one insurance policy for another insurance policy, without recognizing gain or loss. The House Report stated that the purpose of the statute was to overrule decisions under prior law, which had taxed gain putatively realized on exchanges of various types of insurance policies, even though the taxpayer had received no cash (H. Rep. No. 1337, 83d Cong., 2d Sess., 80 (1954)): Under present law, where one insurance policy is exchanged for another, the excess of the value of the policy received over the premiums paid for the exchanged policy is taxable. This has resulted in the taxation of individuals who have merely exchanged one insurance policy for another better suited to their needs and who have not actually realized gain.

The "present law" referred to was represented by *Parsons* v. *Commissioner,* 16 T.C. 256 (1951).

The 1954 change defined the contracts of insurance to which the exemption statute applied as "contract[s] with a life insurance company as defined in section 801 which depends in part on the life expectancy of the insured * * * *" (emphasis added.)

Under the terms of that statute, and the administrative interpretations which followed, nonrecognition was also accorded a taxpayer's exchange of a qualifying policy issued by one company for a qualifying policy issued by another company. Rev. Rul. 72-358, 1972-2 C.B. 473; Rev. Rul. 73-124, 1973-1 C.B. 200. The main requirement was that the insured remain the same under both policies. Ibid; Treasury Regulations, § 1.1035-1(c).

Under the 1954 law, the Internal Revenue Service appears to have broadly interpreted the statutory phrase "contract with *a life insurance company as defined in section 801.*" (Emphasis added.) For example, in Private Letter Ruling 8442010, it held that a taxpayer who exchanged an annuity insurance policy issued by a savings bank, for a similar annuity insurance policy issued by a commercial insurance company, satisfied the above-quoted provision in the statute. The Ruling reasoned that if the insurance department had not been part of the savings bank, and had not been governed by the special rules for savings bank insurance (e.g., Code Section

594), the insurance department would have been taxed as an insurance company under Section 801. Accordingly, it was held that an insurance contract issued by a savings bank qualified for nonrecognition under Section 1035 when upgraded and re-issued by a commercial carrier.

We believe that similar reasoning would have allowed contracts issued by the life insurance departments of fraternal organizations to satisfy the Section 1035 phrase "contract with a life insurance company as defined in section 801", under prior law but our view remains untested administratively. We are certain, however, that if a fraternal society's life insurance department were a separate taxable entity not governed by Section 501(c)(8), it would have been "a life insurance company as defined in section 801," the standard from 1954 to 1984.

The Deficit Reduction Act of 1984 amended the definition of endowment and life insurance contracts eligible for Section 1035 nonrecognition treatment. The law now permits those contracts issued by any insurance company taxable under subchapter L to be exchanged by an individual without the owner being taxed on the previously accrued earnings on his prior policy. Section 224 of the 1984 Act sought to re-focus the tax-free exchange rule on the benefits of the policy rather than on the tax status of the company which is issued the new policy. Its intent was to expand the class of newly issued contracts which qualified the owner for nonrecognition (actually deferred) of gain from his old policy.[1] Thus, Section 1035, as now in force, gives nonrecognition treatment not just to qualifying contracts issued by Section 801 stock life insurance companies, but also to qualifying contracts issued by other types of insurance companies taxed under subchapter L (e.g., mutual life insurance companies). See S. Rep. 98-169, 98th Cong., 2d Sess., 581 (1984); H. Rep. 98-861, 98th Cong., 2d Sess., 1078-1079 (1984).

B. SECTION 1035 TREATMENT AND FRATERNAL BENEFIT SOCIETIES

In prior comments to the Joint Committee, we expressed concern that exempt organizations under section 501 which issue insurance or benefit contracts were overlooked by the 1984 changes.

The reports of the Tax Committees on the 1984 legislation, cited above, do not address the question of equivalent treatment for individuals who are members of nonprofit benefit organizations which issue benefit contracts having similar characteristics as a commercially issued policy, despite substantial comparability of purpose. As your technical corrections proposal stands now, Section 1035 nonrecognition will become available for exchanges of life or annuity contracts by policy holders but only if offered by "insurance companies". H.R. 1800 would change the reference so that such companies no longer need be "subject to tax under subchapter L." It is true that societies such as the Knights of Columbus could be considered insurance companies for this purpose, as the Joint Committees "Description" of proposed Sec. 128 (of H.R. 1800) suggests.[2] However, the fact is that fraternals have never been regarded by the Internal Revenue Service as insurance companies but rather as benevolent organizations, serving communities, families, and churches, as well as its member who are owners of benefit contracts. We can easily imagine a revenue agent examining the income tax return of a member who was involved in a policy upgrading and exchange with our society denying him Section 1035 relief for lack of an explicit provisions in the statute, even after the Sec. 128 current amendment. After all, exemptions from tax are narrowly construed and an examining agent would expect that Congress would address the question of nonprofit insurers of covered policies with precision.

Tax-free treatment of policy exchanges is just as important to the holder of a fraternal benefit policy as it is to the holder of a "traditional" insurance policy. There are many occasions where policyholders of fraternal benefit societies need to exchange an old policy for a new policy. For example, holders of juvenile life insur-

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[1] "The Act amends the definition of an endowment contract and a life insurance contract to include contracts issued by any life insurance company taxable under subchapter L of the Code, rather than just by life insurance companies." General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, Joint Committee Staff Publication, December 3, 1984 at p. 661.

[2] Cf. "Description of the Technical Corrections Act of 1985 (H.R. 1800 and S. 814), Joint Committee Staff Document, April 4, 1985, at pp. 76-77. "The bill [H.R. 1800] amends the definition of an endowment contract and a life insurance contract by merely requiring that the contracts be issued by any insurance company, whether or not such company is a taxable entity under the Code." In O.D. 690, C.B. No. 3, 236 (1920), IRS stated: "A fraternal beneficiary association may be a mutual insurance company, but must be something more. It must be primarily fraternal * * *."

ance policies often issued in face amounts of $500 or $1,000 frequently exchange them for larger policies when they reach adulthood, or when they marry and have their own children and "trade up." Another common example is where the member's wife-beneficiary predeceases him, the member often exchanges his life insurance policy for an annuity policy to pay himself old-age benefits. In addition, older, fixed-premium policies are frequently exchanged for more modern, flexible premium policies.

There is no reason for failing to treat those and other policy exchanges by members of fraternal societies as eligible for nonrecognition treatment. Simply because his fraternal benefit society is not now expressly characterized as an 'insurance company' under the existing Code provisions is no basis for not allowing the same nonrecognition that is given to the issuance of a new policy by a policyholder of a commercial insurance company.[3]

For these reasons, we urge you to consider our proposal to enlarge Section 128 of the Technical Amendments Act of 1985, as set forth in detail in our prior submission. By adding a sentence explicitly including 501(c) organizations, or by clear reference in the pertinent Committee report issued by your Committee, our members will be assured of nonrecognition treatment on exchanges, in line with the 1984 Congressional intent and the intent of your 1985 technical correction.

There should be no revenue affect to this change and we believe the Office of Tax Legislative Counsel of the Treasury Department would not object to it.

Sincerely yours,

WILLIAM J. LEHRFELD.

Enclosure.

LEHRFELD & HENZKE, P.C.,
Washington, DC, March 22, 1985.

Re Proposed technical amendment—section 1035 of the Internal Revenue Code (section 224 of the Tax Reform Act of 1984).

DAVID H. BROCKWAY,
Chief of Staff, Joint Committee on Taxation, Washington, DC.

DEAR MR. BROCKWAY: This firm serves as tax counsel to the Knights of Columbus ("K of C") of New Haven, Connecticut. The organization is a fraternal benefit society with over 1.4 million members in about 7,000 local councils. It is exempt from federal income tax as an organization described in Section 501(c)(8) of the Internal Revenue Code. It provides some 500,000 of its members with life, sick, accident and other benefits, including annuity contracts.

SUMMARY

The purpose of this letter is to request a technical amendment to Section 1035(b) of the Code, which was amended by Section 224 of the Tax Reform Act of 1984. Section 1035 provides for nonrecognition of gain on exchanges of certain specified types of insurance contracts for "for-profit" companies. The 1984 amendment allowed nonrecognition treatment respecting policies issued, not just by life insurance companies defined in Section 801 (as under the prior law), but also respecting policies issued by almost all types of organizations authorized to issue insurance type policies.

Unfortunately, the 1984 amendment used the term "companies subject to tax under subchapter L" to broaden the types of insurance companies to be covered by Section 1035. It was apparently overlooked that many organizations which issue insurance or benefit contracts, such as fraternal benefit societies and tax-exempt annuity issuers, are not taxable under subchapter L, but are instead exempt under Section 501. Your General Explanation (the "Bluebook") of the Deficit Reduction Act of 1984 (December 31, 1984) (p. 661) attempted to correct this omission of Section 501 insurance issuers, but the Bluebook's statement appears to exceed the express terms of the statute. The Reports of the Tax Committees, including the Conference Report, do not address the question of equivalent treatment for nonprofit benefit organizations.

Accordingly, Section 1035(b)(1) should be amended to provide by law that Section 1035 applies to benefit contracts which are issued by fraternal societies, and other Section 501(c) organizations, that would be taxable under subchapter L, but for their

[3] Even if the Knights of Columbus was subject to the same state of regulations as for-profit carriers, IRS could disregard its status for federal tax purposes because of national policy considerations. See GCM 6782, C.B. VIII-2, 209 (1929), where IRS holds that a carrier's status under the states' insurance laws is not conclusive and binding for federal tax purposes.

explicit exemption description under Section 501(c). The text of the proposed "amendment" is set forth at p. 8, infra.

DETAILED DISCUSSION

1. Pre-1984 law

Section 1035 was enacted in 1954 as part of the Internal Revenue Code's general revision to allow a taxpayer to exchange one insurance policy for another insurance policy, without recognizing gain or loss. The House Report stated that the purpose of the statute was to overrule prior law, which had taxed gain realized by taxpayers on exchanges of various types of insurance policies, even through the taxpayer had received no cash (H. Rep. No. 1337, 83d Cong., 2d Sess. 80 (1954)): Under present law, where one insurance policy is exchanged for another, the excess of the value of the policy received over the premiums paid for the exchanged policy is taxable. This has resulted in the taxation of individuals who have merely exchanged one insurance policy for another better suited to their needs and who have not actually realized gain. See, e.g., *Parsons* v. *Commissioner*, 16 T.C. 256 (1951).

The 1954 law defined the contracts of insurance to which the statute applied as "contract[s] with a life insurance company as defined in section 801 which depends in part on the life expectancy of the insured * * * *" (Emphasis added.) The 1954 statute thus provided:

SEC. 1035. CERTAIN EXCHANGES OF INSURANCE POLICIES.

(a) GENERAL RULES.—

(1) a contract of life insurance for another contract of life insurance or for an endowment or annuity contract; or

(2) a contract of endowment insurance (A) for another contract of endowment insurance which provides for regular payments beginning at a date not later than the date payments would have begun under the contract exchanged, or (B) for an annuity contract; or

(3) an annuity contract for an annuity contract.

(b) DEFINITIONS.—For the purpose of this section—

(1) ENDOWMENT CONTRACT.—A contract of endowment insurance is a contract with a life insurance company as defined in section 801 which depends in part on the life expectancy of the insured, but which may be payable in full in a single payment during his life.

(2) ANNUITY CONTRACT.—An annuity contract is a contract to which paragraph (1) applies but which may be payable during the life of the annuitant only in installments.

(3) LIFE INSURANCE CONTRACT.—A contract of life insurance is a contract to which paragraph (1) applies but which is not ordinarily payable in full during the life of the insured.

(c) CROSS REFERENCES.—

(1) For rules relating to recognition of gain or loss where an exchange is not solely in kind, see subsections (b) and (c) of section 1031.

(2) For rules relating to the basis of property acquired in an exchange described in subsection (a), see subsection (d) of section 1031.

Under the terms of the 1954 statute, and the administrative interpretations of the Internal Revenue Service, nonrecognition was also accorded a taxpayer's exchange of a qualifying policy issued by one company for a qualifying policy issued by another company. Rev. Rul. 72-358; 1972-2 C.B. 473; Rev. Rul. 73-124, 1973-1 C.B. 200. The main requirement was that the insured remain the same under both policies. Ibid; Treasury Regulations, Section 1.1035-1(c).

Under the 1954 law, the Service appears to have broadly interpreted the statutory phrase "contract with *a life insurance company as defined in section 801.*" (Emphasis added.) For example, in Private Letter Ruling 8442010 (attached), the Service held that a taxpayer who exchanged an annuity insurance policy issued by a savings bank, for a similar annuity insurance policy issued by a commercial insurance company, satisfied the above-quoted provision in the statute. The Ruling reasoned that if the insurance department had not been part of the savings bank, and had not been governed by the special rules for savings bank insurance (e.g., Code Section 594), the insurance department would have been taxed as an insurance company under Section 801. Accordingly, the Service held that the insurance contract issued by the savings bank qualified for nonrecognition under Section 1035 where it was re-issued by the commercial carrier.

We believe that a similar reasoning allowed contracts issued by the life insurance departments of fraternal organizations to satisfy the Section 1035 phrase "contract with a life insurance company as defined in section 801." For if a fraternal society's

life insurance department were a separate taxable entity not covered by Section 501(c)(8), it would be "a life insurance company as defined in section 801."

2. The 1984 amendment

Section 224 of the Tax Reform Act of 1984 deleted the phrase "contract with a life insurance company as defined in section 801," and substituted the phrase "contract with an insurance company subject to tax under subchapter L." The purpose of this amendment was to expand the class of insurance contracts which qualified for Section 1035 nonrecognition, by focusing on the character and benefits of the contract, rather than the particular tax status of the issuer. Thus, the amendment by its terms gives nonrecognition treatment, not just to qualifying contracts issued by Section 801 stock life insurance companies, but also to qualifying contracts issued by other types of insurance companies taxed under subchapter L (e.g., mutual insurance companies). See S. Rep. 98-169, 98th Cong., 2d Sess. 581; H. Rep. No. 98-861, 98th Cong., 2d Sess. 1078-1079.

The broader language in the 1984 amendment does not explicitly include the contracts issued by insurance departments of nonprofit organizations. The Bluebook attempted to mitigate this problem by stating that the amended statute should apply to insurance contracts issued by insurance companies which would be taxed under subchapter L if not for a more specific exemption under Section 501: The Act amends the definition of an endowment contract and a life insurance contract to include contracts issued by any insurance company taxable under subchapter L of the Code, rather than just by life insurance companies. This change in law was intended to recognize that the focus of the exchange rule should be on the character and benefits of the contract rather than the particular tax status of the company issuing the contract. Because of this express intent, *the definition of an endowment contract and a life insurance contract should be interpreted as including also those contracts issued by an insurance company that would be taxable under subchapter L, but for a specific tax-exemption under section 501 or some other provision.* (Emphasis added.)

Unfortunately, the Bluebook statement has no specific corollary in the House, Senate or Conference Reports, or the debates on the Deficit Reduction Act of 1984 recorded in the Congressional Record. As you know, the Internal Revenue Service has taken the position that the Bluebook is not "substantial authority" for purposes of avoiding penalties for understatements of income.[1]

Despite its general acceptance by the tax bar, the Bluebook is not sufficient authority for the IRS to protect the members of the Knights of Columbus, and other fraternal societies, on this point who must advise their members about policy exchanges and Section 1035. This predicament imposes a hardship and uncertainty where none should be.

3. Proposed amendment

To carry out the intent of Congress, we request that the 1985 Technical Amendments Act include a revision of Section 1035(b) so it reads as follows:

(b) DEFINITIONS.—For the purpose of this section—

(1) ENDOWMENT CONTRACT.—A contract of endowment insurance is a contract with an insurance company subject to tax under subchapter L *(or with an issuer of a contract that would be taxable under subchapter L, but for section 501)* which depends in part on the life expectancy of the insured, but which may be payable in full in a single payment during life. (Emphasis added.)

By expressly covering this question in a technical amendment, policyholders in all types of insurance companies would be treated equally, and a trap for unwary policyholders would be eliminated. We assume the effective date of such a technical amendment would coincide with the effective date provision of the pertinent provisions of Section 224 of the Deficit Reduction Act of 1984.

Please do not hesitate to telephone the undersigned if you have any questions regarding the proposal.

Sincerely yours,

WILLIAM J. LEHRFELD.
LEONARD J. HENZKE, Jr.

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[1] See "Tax Compliance: 'Bluebook' Not Substantial Authority in Final Penalty Rules, Egger Says," BNA Daily Tax Reporter, March 14, 1985, p. G-4.

CONGRESS OF THE UNITED STATES,
HOUSE OF REPRESENTATIVES,
Washington, DC, May 22, 1985.

Hon. DAN ROSTENKOWSKI,
Chairman, Ways and Means Committee, Washington, DC.

DEAR CHAIRMAN ROSTENKOWSKI: I am writing on behalf of a constituent who has expressed concern over the effective date of the stock redemption section of the earnings and profits provision of the Deficit Reduction Act of 1984 (sec. 61 of the Act, sec. 312 of the Internal Revenue Code.) I have attached a copy of a letter he has written to Senator Armstrong detailing the difficulties caused by the effective date of that section, the date of enactment, as it relates to Subchapter "S" corporations.

I would appreciate your consideration of his concerns, and particularly whether the effect he describes was intended. As H.R. 1800—the Technical Corrections Act—is pending before Ways and Means, I am inquiring into the possibility of amending the section in question to become effective January 1, 1985.

Also, I would appreciate your including the letter as part of the hearing transcript from the hearing held May 16th on the Technical Corrections Act. Thank you for this consideration.

Sincerely,

KEN KRAMER.

Enclosure.

LENTZ, EVANS AND KING, P.C.,
Denver, CO, May 7, 1985.

Re Technical Corrections Act of 1985 Silco Fuels, Inc.

Senator WILLIAM ARMSTRONG,
Hart Senate Building, Washington DC.

DEAR SENATOR ARMSTRONG: I am writing this letter on behalf of my client, Silco Fuels, Inc., a Colorado corporation and its principal stockholder, Robert A. Silverberg of Denver, Colorado. On December 12, 1984, Silco Fuels, Inc. redeemed the shares of one of its stockholders, George W. Heyburn, for an aggregate consideration of $1,000,000. As a result of the redemption, Robert A. Silverberg is the sole stockholder of the corporation, a Subchapter S Corporation, which at the time of the redemption had earnings and profits of approximately $1,014,998. Silco Fuels, Inc. is in the diesel distributing business and also real estate business. It is the intention of the sole shareholder to terminate Silco Fuels, Inc.'s activities in the diesel distributing business and remain solely as a Subchapter S Corporation in the real estate business. However, it cannot remain as a qualified Subchapter S corporation if it engages only in the rental of real estate receiving "passive income" and has earnings and profits.

Under the law prior to the Deficit Reduction Act of 1984, earnings and profits were reduced on a distribution by a corporation in a redemption of shares of its own stock in an amount equal to the excess of the amount of the distribution over the amount "properly chargeable" to the corporation's capital account. In applying this rule, some cases held, and the IRS eventually ruled, that a corporation's capital account was an amount equal to the par value of its stock plus the amount, if any, of paid-in surplus. See e.g., *Jarvis* v. *Commissioner*, 43 B.T.A. 439, aff'd., 123 F.2d 742 (4th Cir. 1941) and Rev. Rul. 79-376, 179-2 C.B. 133.

Section 312(n)(8) changed the prior law relating to the computation of earnings and profits of a corporation. New Paragraph (8) deals with redemptions and provides that if a corporation distributes an amount in a redemption, the part of such redemption which is properly chargeable to earnings and profits shall be an amount which is not in excess of the ratable charge of the earnings and profits of such corporation attributable to the stock redeemed.

The effect of the charge to earnings and profits under prior law, would be approximately $1,000,000 as opposed to approximately $333,000 under the Deficit Reduction Act of 1984. Accordingly, without substantial adverse tax consequences, Silco Fuels, Inc. cannot terminate its diesel distributing operation and remain a Subchapter S corporation.

The Senate Committee Report in discussing the provision relating to redemptions, stated "This provision is applicable with respect to the effect on earnings and profits of distribution in taxable years beginning after the date of enactment." The Conference Committee Report stated that the Conference agreement is generally the same as the Senate amendment and made no reference to the effective date. The Bill, as enacted stated no effective date for the provision of § 312(n)(8) and therefore it was deemed to be the date of enactment, or July 18, 1984. The Technical Corrections Act

of 1985 (House Bill 1800 and Senate Bill 814) introduced March 28, 1985, contains revisions to the Deficit Reduction Act of 1984 which are intended to clarify and conform various provisions adopted by the original legislation. One such clarification is to provide for an effective date to Section 312(n)(8) to make it clear that it applies to redemption distributions after July 18, 1984 (Section 104(e) of the Technical Corrections Act). It is respectfully submitted that such amendment should provide that it applies only in tax years beginning after July 18, 1984 as provided in the Senate Committee Reports, and not for transactions occurring after the effective date of the Deficit Reduction Act.

This transaction was in the negotiating stage in excess of eight months or more prior to the adoption of the Deficit Reduction Act. Delay in finalizing the matter occurred in substantial part because of Mr. Heyburn's health. At the time the transaction was effected, it was fully expected that the "oversight" of the effective date would be corrected to conform with the Senate Committee's recommendation. While it is not possible to represent that the transaction would not have been effected under any condition, taxpayers should be entitled to at least complete their fiscal year based on prior law. Accordingly, on behalf of my client, Silco Fuels, Inc. and Robert A. Silverberg, it is respectfully requested that you submit a change to Section 104(e) of the Technical Corrections Act bill as submitted providing that: "The provisions of Paragraph 8 of Section 312(n)(2) of such Code shall apply to redemption made in taxable years beginning after July 18, 1984."

If you have any questions or desire additional amplification, we would be happy to provide it. Thank you for your consideration of this matter.

Yours truly,

LENTZ, EVANS AND KING, P.C.

STATEMENT OF ROBERT A. WHERRY, JR., LENTZ, EVANS AND KING P.C., ON BEHALF OF SILCO FUELS, INC., A COLORADO CORPORATION

SUMMARY OF PRINCIPAL POINTS

The Deficit Reduction Act of 1984, enacting new Section 312(n)(8) of the Internal Revenue Code of 1954, as amended ("IRC"), changed the rules relating to the computation of a corporation's accumulated earnings and profits after a stock redemption. HR 4170, the House version of the Deficit Reduction Act of 1984, did not contain this provision. The genesis of the provision was the Senate Finance Committee Report approved by the Finance Committee on March 21, 1984.[1] The proposed effective date for this new provision was established by Section 47(d)(1)(A) of the Senate Bill, which provided that: "Except as provided in this paragraph, the amendments made by subsection (a) shall apply to amounts paid or incurred in, or distributions or redemptions occurring in, taxable years beginning after the date of the enactment of this Act."[2]

The Senate Finance Committee explanation[3] provided that: "This provision is applicable with respect to the effect on earnings and profits of distributions in taxable years beginning after the date of the enactment."

The Conference Committee Report to accompany HR 4170[4] contains the Senate Finance Committee redemption provision at pages 93 and 94. Subparagraph "(e)" of § 61 contains effective dates for paragraphs (1), (2), (3), (4), (5), and (7) of new IRC § 312(n), but, without explanation, failed to contain an effective date for paragraph (8), the redemption provision. However, the narrative portion of the Conference Committee Report dealing with redemption provision, contained on page 838 of the Conference Committee Report, states: "The Conference agreement generally follows the Senate amendment with several modifications."

Because the redemption provision came from the Senate Finance Committee Report, the Conference Committee Report adopted the Senate substantive provison unaltered, and because the Conference Committee Report indicated it generally followed the Senate Report, Silco presumed that the effective date for the redemption provision would be the same as contained in the Senate Report, i.e., effective for taxable years beginning after the date of enactment.

To correct the apparent oversight in the Conference Committee Report which failed to include a specific effective date for the new redemption provision, IRC

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[1] The specific provision involved was contained in Title 1, Sub-Title D, Part 3, Section 47(a)(1) (located on page S-58 of the BNA Special Supplement, DER #67, April 6, 1984, Vol. 2.

[2] Contained on Page S-60 BNA, Vol. 2

[3] Contained on Page S-59 BNA, Vol. 1, BNA Special Supplement, DER #66, April 5, 1984.

[4] § 61(a)(1), page 92 of the Government Printing Office Report.

§ 312(n)(8), the Technical Corrections Act of 1985 (HR 1800 and Senate Bill 814) contains in § 104(e) a provision establishing an effective date of July 18, 1984. Because of the history of the redemption provision, Silco believes a more appropriate effective date would be one effective for taxable years beginning after July 18, 1984.

GENERAL DISCUSSION

On December 12, 1984, Silco Fuels, Inc. ("Silco"), a corporation taxable under Subchapter S of the Internal Revenue Code of 1954, as amended ("IRC"), redeemed the shares of one of its principal shareholders for an aggregate consideration of One Million Dollars. Immediately before the redemption, Silco had earnings and profits slightly in excess of One Million Dollars.

Silco has been in the diesel oil distributing and real estate businesses. It is Silco's intention to terminate its diesel oil distribution business and retain its real estate business. However, from a practical tax viewpoint, it cannot remain as a qualified Subchapter S corporation if it engages only in the real estate business receiving "passive income" and has accumulated earnings and profits while it was a corporation taxable under IRC Subchapter C.

Under the law, prior to the Deficit Reduction Act of 1984, earnings and profits were reduced on a distribution by a corporation in a redemption of shares of its own stock in an amount equal to the excess of the amount of the distribution over the amount "properly chargeable" to the corporation's capital account. In applying this rule, some cases held, and the Internal Revenue Service eventually ruled, that the amount properly chargeable to a corporation's capital account was an amount equal to the par value of its stock plus the amount, if any, of paid-in surplus. See e.g., *Jarvis* v. *Comm.*, 43 BTA 439, aff'd 123 F2d 742 (4th Cir. 1941) and Revenue Ruling 79-376, 179-2 CB 133.

Section 312(n)(8) changed the prior law relating to the computation of earnings and profits of a corporation. New paragraph (8) deals with redemptions and provides that if a corporation distributes an amount in a redemption, the part of such redemption which is properly chargeable to earnings and profits shall be an amount which is not in excess of the ratable charge of the earnings and profits of such corporation attributable to the stock redeemed.

The effect of the change to Silco's earnings and profits under prior law would be approximately One Million Dollars as opposed to approximately one-third of this amount under the Deficit Reduction Act of 1984. Accordingly, without substantial adverse tax consequences, Silco cannot terminate its diesel oil distributing operation and remain a Subchapter S corporation.

The Senate Committee Report, in discussing the provision relating to redemptions, stated: "This provision is applicable with respect to the effect on earnings and profits of distributions in taxable years beginning after the date of enactment."

The Conference Committee Report stated that the Conference agreement is generally the same as the Senate amendment and made no reference to the effective date. The Bill, as enacted, stated no effective date for the provision of § 312(n)(8), and, therefore, it was deemed to be the date of enactment, July 18, 1984. The Technical Corrections Act of 1985, introduced March 28, 1985, contains revisions to the Deficit Reduction Act of 1984 which are intended to clarify and conform various provisions adopted by the original legislation. One such clarification, contained in § 104(e) of the Act, is to provide a specific effective date for § 312(n)(8). This proposed provision states that IRC § 312(n)(8) applies to redemption distributions after July 18, 1984. It is respectfully submitted that such amendment should provide that it applies only to distributions in tax years beginning after July 18, 1984, as provided in the original Senate Committee Report, and not for transactions occurring after the effective date of the Deficit Reduction Act of 1984.

The Silco redemption giving rise to this letter was in the negotiating stage in excess of eight months prior to the adoption of the Deficit Reduction Act of 1984. Delay in finalizing the matter occurred, in substantial part, because of the redeemed shareholder's health. At the time the transaction was effected, it was fully expected that the "oversight" of the effective date would be corrected to conform with the Senate Committee's recommendation.

While it is not possible to represent that the transaction would not have been effected under any condition, taxpayers, including Silco, should, based on the history of this provision, be entitled to at least complete their fiscal year under prior law. Accordingly, it is respectfully requested that the Committee amend Section 104(e) of the Technical Corrections Act bill as submitted, to provide that: "The provisions of Paragraph 8 of Section 312(n) of such Code shall apply to redemptions made in taxable years beginning after July 18, 1984."

We appreciate the Committee's consideration of our request, and we urge you to act favorably on this proposed amendment.

STATEMENT OF JOHN G. MILLIKEN AND PAUL BOUSQUET, COUNSELS, LA CHOY FOOD PRODUCTS

La Choy Food Products, a subsidiary of the Beatrice Companies, Inc., and a major importer of processed oriental vegetables, strongly supports H.R. 1800, Section 228 of which would make the elimination of tariffs on certain imported vegetables retroactive to June 30, 1983.

Section 115 of the Trade and Tariff Act of 1984 permanently removed the tariff duty on imported processed water chestnuts and bamboo shoots. The legislative intent clearly was to make that elimination retroactive to June 30, 1983, the date the prior three-year suspension of the tariff duty terminated. The Conference Report states that the Act "[p]rovides for permanent column 1 duty-free treatment for water chestnuts and bamboo shoots retroactive to June 30, 1983." H.R. Rep. No. 98–1156, 98th Cong., 2nd Sess. 104 (1984). The retroactivity provision, however, inadvertently was omitted from the final version of the Act, along with retroactivity provisions intended to be applicable to four other tariff modification sections (Sections 112, 118, 167, and 169).

A colloquy on the House floor between Representatives Frenzel and Kazen in the final days of the last Congress also indicated that this oversight was inadvertent and that the Ways and Means Committee would take the first opportunity in the present Congress to correct the oversight. 130 Cong. Rec. 12,283–84 (October 12, 1984).

On November 29, 1984, Senator Danforth, Chairman of the Subcommittee on International Trade of the Committee on Finance, and Representative Gibbons, Chairman of the Subcommittee on Trade of the Ways and Means Committee, sent a joint letter to William von Raab, Commissioner of the U.S. Customs Service, informing the Commissioner of the congressional intent to remedy this oversight by introducing technical correction legislation in the present Congress.

Failure to enact the technical correction legislation would result in an anomalous situation in which processed water chestnuts and bamboo shoots imported between June 30, 1983, and November 14, 1984 (the effective date of the Trade and Tariff Act of 1984) would be subject to duty, while the same articles imported either prior or subsequent to that period would not be dutiable. Failure to enact the technical correction legislation, moreover, would result in substantial cost and inconvenience to firms situated like La Choy. Some of these costs undoubtedly would be passed on to consumers in the form of higher prices.

STATEMENT OF PAUL H. LANE, GENERAL MANAGER, DEPARTMENT OF WATER AND POWER, CITY OF LOS ANGELES

Mr. Chairman, the following statement is meant to clarify an issue on which the Committee took a firm stand during the deliberations in respect of the Tax Reform Act of 1984, but which has subsequently become clouded by certain provisions of the proposed Technical Corrections Act of 1985 (H.R. 1800). Specifically, I refer to the financing of the Mead-Phoenix Project.

The Mead-Phoenix Project is a joint participation project of public bodies in California and Arizona, and the Western Area Power Administration of the United States Department of Energy (which I refer to as Western). The participants in California are the Southern California Public Power Authority, acting for the Cities of Los Angeles, Anaheim, Azusa, Banning, Burbank, Colton, Glendale, Pasadena, Riverside and Vernon; and the M-S-R Public Power Agency, acting for the Cities of Santa Clara and Redding and the Modesto Irrigation District. The Arizona public body is the Salt River Project Agricultural Improvement and Power District in Phoenix, Arizona.

The Mead-Phoenix Project will be a high-voltage direct current transmission line which will enable the participants to make economical energy purchases and transfers through increased transmission capability, and will assist Western in meeting energy delivery requirements to its wholesale customers as required by federal law. The preliminary estimate of construction costs of the Mead-Phoenix Project is approximately $500 million. It is estimated that the Project will be in service in 1990.

During the deliberations on the Tax Reform Act of 1984, it was brought to the Committee's attention that further tax-exempt financing of this valuable project was jeopardized as a result of the prohibition on federal guarantees contained in

that Act. The concern was that the participation of Western might be viewed as a prohibited federal guarantee. In light of the value of the Project to the project participants, including Western, and the financial commitments which had been previously made, including a $14.1 million issue of notes to finance development and related costs of the Project, a specific "grandfathering" clause was included in the 1984 Tax Act to preserve tax exemption for interest on obligations to finance the Mead-Phoenix Project. This grandfather provision was included as Section 632(d) of the 1984 Tax Act.

Accordingly, the Committee and the Congress have already considered the Mead-Phoenix Project and have taken action in the 1984 Tax Act specifically to preserve the tax exemption of interest on obligations issued with respect to the Mead-Phoenix Project, notwithstanding the participation of Western.

Although the Congress protected the Mead-Phoenix Project in the 1984 Tax Act, a provision of the Technical Corrections Act of 1985 (which, as you know, amends the 1984 Tax Act) would undermine that protection. This undermining would occur because the bonds to finance the Mead-Phoenix Project could, under the Technical Corrections Act, run afoul of the "consumer loan bonds" provisions.

Beside dealing with "federal guarantees" and other issues, the 1984 Tax Act added Section 103(o) to the Code, providing that interest on obligations would not be tax-exempt if they are "consumer loan bonds." Section 103(o) of the Code provides that a bond is a taxable consumer loan bond if five (5%) percent or more of the proceeds are reasonably expected to be used, directly or indirectly, to make loans to non-exempt persons. Such non-exempt persons would include the federal government, including Western. Western is the only non-exempt person participating in the Mead-Phoenix Project, but it has taken a twenty percent (20%) interest in the Mead-Phoenix Project.

When the 1984 Tax Act was passed, the consumer loan bond provisions did not apply to the Mead-Phoenix Project. Among the transitional rules contained in the 1984 Tax Act was Section 631(c)(3) which provided that the amendments made by the 1984 Tax Act did not apply to obligations with respect to facilities "with respect to which a binding contract to incur significant expenditures was entered into by October 19, 1983." Because of the contractual arrangements previously entered into by the participants with respect to the Mead-Phoenix Project, even if the arrangements with Western (the only non-exempt person involved) produced "consumer loan bonds", the transitional rule provisions of Section 631(c)(3) made the consumer loan bond provisions inapplicable to the Mead-Phoenix Project.

The problem arises now, however, because Section 169 of the Technical Corrections Act would revise the transitional rule set forth in Section 631(c)(3) of the 1984 Tax Act so that the consumer loan bond provisions of Section 103(o) of the Code would apply to the financing of the Mead-Phoenix Project. As a result, if the arrangements with Western were to be treated as a loan for tax purposes, interest on bonds issued by Southern California Public Power Authority to finance the Mead-Phoenix Project would not be tax-exempt. Accordingly, the protection of the tax-exempt status of bonds for the Mead-Phoenix Project specifically approved by Congress in Section 632(d) of the 1984 Tax Act would be negated by a "technical correction", to the same Act. Further, as discussed in previous testimony to the Committee, absence of the tax exemption could well cause abandonment of the Mead-Phoenix Project.

Because it was clearly the intent of the Congress when it enacted the Tax Reform Act of 1984 to specifically preserve the tax exemption of interest on obligations issued for the Mead-Phoenix Project, we feel it is reasonable to expect Congress to preserve this exemption in the technical amendments.

I appreciate your consideration of this matter and we want to cooperate with the Committee in finding a feasible solution to this problem. To this end I would like to suggest the accompanying language, which is similar to the existing Mead-Phoenix Project "federal guarantee" grandfather clause, and would continue the exclusion of obligations issued by Southern California Public Power Authority for the Mead-Phoenix Project from the consumer loan bond provisions.

The following would be added to Section 170 of The Technical Corrections Act of 1985:

AMENDMENTS RELATED TO SECTION 632 OF THE ACT

Subsection (d) of Section 632 of the Tax Reform Act of 1984 is amended—

(1) by deleting the "." at the end of the subsection heading and adding in lieu thereof ", ETC."; and

(2) by deleting all words prior to paragraph (A) and adding in lieu thereof "Obligations (including refunding obligations) shall not be subject to sections 103(h) or 103(o) of the Internal Revenue Code of 1954 if—".

MILLER & CHEVALIER,
Washington, DC, April 4, 1985.

Hon. DAN ROSTENKOWSKI,
House of Representatives, Rayburn House Office Building, Washington, DC.

DEAR MR. ROSTENKOWSKI: I request, on behalf of our client The May Department Store Company, your consideration of a technical correction to the Tax Reform Act of 1984 ("TRA") involving the rehabilitation investment credit. The technical correction is needed to conform the treatment of lessors of section 593 organizations, which are taxable entities, with that accorded lessors of tax exempt entities when the leased property is a qualified rehabilitated building eligible for the rehabilitation investment credit.

Before the TRA, lessors of tax exempt entities and section 593 organizations were eligible to claim the full rehabilitation investment credit for qualified rehabilitated buildings without restriction. The availability of the full credit to lessors of tax-exempt entities was an exception to the general disallowance of investment credits for property used by exempt entities. Similarly, although section 46(e)(1) and (2) reduced by 50 percent all investment credits claimed by section 593 organizations, lessors of such organizations were not affected by this limitation. The limitation for section 593 organizations, defined as "a mutual savings bank, domestic building and loan association or cooperative bank without capital stock organized and operated for mutual purposes and without profit," and commonly referred to as "thrift institutions," was enacted in 1962, due to the favorable tax treatment of such organizations, including the bad debt reserve deduction allowed under section 593(b) of the Code.

The TRA amendments to sections 46(e) and 48(g) have the anomalous effect of treating lessors of tax-exempt entities more favorably than lessors of section 593 organizations with respect to the rehabilitation investment credit. TRA section 31(c) amended section 48(g) of the Code to limit the availability of the rehabilitation investment credit for buildings leased to tax-exempt entities. A full credit is still available, however, if the leased property is not, and may not reasonably be expected to be, "tax-exempt use property" under section 168(j)(3) of the Code. TRA section 31(f) added section 46(e)(4) to the Code to impose on lessors of section 593 organizations the general investment credit limitation applicable to those organizations, unless the lease is less than six months or the lessee irrevocably elects to forgo its favorable section 593 method of computing bad debt reserve deductions. Thus, a lessor of a section 593 organization would be entitled to only 50 percent of the rehabilitation investment credit under circumstances where the full credit would be available if the lessee were a tax-exempt entity.

The enclosed amendment to the Technical Corrections Act of 1985, H.R. 1800, preserves the full rehabilitation investment credit for lessors of section 593 organizations only in the limited circumstances where the full credit would be available if the lessee were a tax-exempt entity. The proposed amendment creates, for purposes of the rehabilitation investment credit, an exception to the section 46(e)(4) classification of the lessor as a section 593 organization if the leased property would not be classified as "tax-exempt use property" were the lessee a tax-exempt entity, rather than a section 593 organization. The amendment is intended to take effect as if it were included in the provision of the TRA to which it relates.

I would greatly appreciate your consideration of this amendment and would welcome the opportunity to answer any questions you may have about it.

Very truly yours,

MELISSA THOMAS MAY,
(On behalf of May Department Stores).

Enclosure.

TECHNICAL CORRECTIONS ACT OF 1985

SEC. 102. AMENDMENTS RELATING TO TAX-EXEMPT ENTITY LEASING PROVISIONS

(a) Amendments Relating to Section 31 of the Act.

Insert the following before existing Sec. 102(a)(8) "Clerical Amendments":

(8) EXCEPTION FOR QUALIFIED REHABILITATED BUILDINGS LEASED TO SECTION 593 ORGANIZATIONS.—Paragraph (4) of section 46(e) (relating to special rules where

section 593 organization is lessee) is amended by adding at the end thereof the following new subparagraph:

"(D) EXCEPTION FOR QUALIFIED REHABILITATED BUILDINGS LEASED TO SECTION 593 ORGANIZATIONS.—Subparagraph (A) shall not apply to qualified investment attributable to qualified rehabilitation expenditures for any portion of a building if such portion of the building would not be (and would not reasonably be expected to be) tax-exempt use property (as defined in section 168(j)(3)) if the section 593 organization were a tax-exempt entity (as defined in section 168(j)(4))."

Effective date: This amendment shall take effect as if included in the provision of the Tax Reform Act of 1984 to which such amendment relates. (See sec. 181 of the Technical Corrections Act of 1985.)

MAYER, BROWN & PLATT,
Washington, DC, May 29, 1985.

Re Technical Corrections Act of 1985 (H.R. 1800)—Code section 168(f)(10).

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means, Washington, DC.

DEAR MR. CHAIRMAN: This statement is submitted for the record of your May 16, 1985, hearing.

SUMMARY OF RECOMMENDATION

Technical Corrections Act section 109(b)(1) would make important and unanticipated substantive modifications to the Code section 168(f)(10) step-in-the-shoes depreciation rules. Therefore, a prospective effective date which gives taxpayers fair notice of the proposed changes is required.

BACKGROUND

The Deficit Reduction Act of 1984 ("DEFRA") extended the ACRS recovery period for real property from 15 to 18 years. No change was made in the recovery period for 5-year property.

Current Code section 168(f)(10)(A) and (B)(iii) treats the transferee in a sale-leaseback transaction as the transferor for purposes of computing the ACRS deduction with respect to so much of the subject property's basis as does not exceed the transferor's adjusted basis.

Thus, under existing law, if a transferor of real property elected 15-year straight line depreciation, his transferee would step-into-the-transferor's-shoes, i.e., continue to use the straight line rate for 15-year real property over the remaining portion of the 15-year period with respect to so much of the property's basis as does not exceed the transferor's adjusted basis.

Nevertheless, the General Explanation of the Revenue Provisions of DEFRA prepared by the staff of the Joint Committee on Taxation (the "Blue Book") indicated at page 329 that "the Congress intended different results". More specifically, the Blue Book indicated that "the Congress generally intended that the new rules [i.e., 18 year depreciation] would be fully applicable to real property qualifying as recovery property in the hands of the transferee unless the transferor had made an election with respect to the property under section 168[(b)](3)", i.e., had elected straight line depreciation over 15, 35, or 45 years. The Blue Book also indicated that "a technical amendment will be recommended in this regard". However, its details were not disclosed.

It was generally understood that the Joint Committee staff intended to recommend a substantive amendment which would preclude sale-leasebacks designed to obtain faster depreciation, i.e., an anti-churning rule to preclude using 18-year depreciation of real property where a transferor had elected 35- or 45-year straight line depreciation. There was no Blue Book indication of any contemplated change in step-in-the-shoes depreciation for 5-year property.

In reliance on existing law and the Blue Book statements, a large sale-leaseback transaction involving primarily real property and some personality was closed on April 5, 1985. The transferor had elected 15-year straight line depreciation under section 168(b)(3) as it applied before the enactment of DEFRA. It was, thus, understood that the transferee would, under current law, step-into-the-shoes of the transferor and continue to use 15-year straight line depreciation for the real property and 5-year accelerated depreciation for the 5-year property, the transferee, in both cases, assuming the transferor's ACRS schedule in mid-stream.

As a brief overview, the transaction involved two unrelated corporate owner-participants, their respective parents, an institutional lender, an owner-trustee, a corporate lessee, its parent, a corporate remainderman, and its parent. The documents reflecting the transaction are voluminous and considerable effort was expended negotiating and documenting the transaction in reliance on existing law.

In brief outline, the key dates regarding the transaction are:

(1) January 16, 1985—lender issued its original commitment.

(2) January 31, 1985—

(a) Letter signed among owner-participant, lessee, and remainderman, subject to necessary approvals.

(b) Approval granted by investment committee of owner-participant.

(c) Approval granted by executive committee of lessee.

(3) March 6 and 7, 1985—extensive negotiations concluded with agreement reached on all major definitive terms of documents.

(4) March 22, 1985—lender's commitment finalized.

(5) April 5, 1985—transactions closed.

PROBLEM

Section 109(b)(1) of the Technical Corrections Act would amend Code section 168(f)(10)(A)(ii) to provide: "if the transaction is described in clause (ii) or (iii) [i.e., is a sale-leaseback] of subparagraph (B) and the transferor made an election with respect to such property under subsection (b)(3) or (f)(2)(C), the transferee shall be treated as having made the same election (or its equivalent)."

The amendment would apply to property placed in service by a transferee after March 28, 1985, the date the Technical Corrections Act was introduced. Act section 109(b)(3).

The description of the Act prepared by the staff of the Joint Committee is dated April 4, 1985, but it did not become generally available to the public until several days later. At page 27, it explained for the first time that the "(or its equivalent)" language of proposed Code section 168(f)(10)(A)(ii) is intended to require that "if the transferor was depreciating 15-year real property on a straight line basis, the transferee would be treated as having elected 18-year straight line depreciation"; that "the transferee starts depreciating the property as would any other new owner of it"; and that this change would apply to both 15-year real property and 5-year property.

Clearly, no taxpayer or its advisor could have been expected on March 28, 1985, to anticipate these proposed substantive changes. Nor could anyone on that date fairly be expected to have a copy of the bill available; to be able to locate within its 225 pages the proposed amendment; or to understand its proposed application.

The proposed March 28, 1985, effective date (rather than the even more retroactive DEFRA effective date) is an implicit recognition that the proposed amendments are important substantive changes that could not be fairly anticipated. Full fairness demands at a minimum that the amendments become effective only after taxpayers and their advisors have a decent opportunity after introduction to become aware of the proposals and their intended application.

PROPOSED SOLUTION

Taxpayers and their advisors are entitled to a minimum of 30 days in which to become familiar with proposed changes in existing law. Accordingly, the effective date in Act section 109(b)(3) should be modified to apply to property placed in service by a transferee after April 28, 1985.

As possible alternatives, it has been suggested (1) that the proposed amendments should be made effective with respect to property placed in service after the date your Committee takes action or (2) specific transactions should be excepted from the general effective date.

Our principal concern, of course, is that the transaction described above not be made subject to the proposed new rules. Accordingly, either of the alternatives would be satisfactory. Nevertheless, either an April 28, 1985, effective date or the first alternative seem "cleaner" and fairer, i.e., either would protect all parties for a reasonable "notice" period, not just those who have the sophistication and resources to make their concerns known to your Committee.

I would welcome the opportunity to answer any question or to discuss this matter with you or your staff.

Respectfully submitted,

JERRY L. OPPENHEIMER.

MAYER, BROWN & PLATT,
Washington, DC, May 28, 1985.

Re Technical Corrections Act of 1985 (H.R. 1800)—Code section 267.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means, House of Representatives, Washington, DC.

DEAR MR. CHAIRMAN: This statement is submitted for the record for your May 16, 1985, hearing.

SUMMARY OF RECOMMENDATION

A technical correction to Code section 267 is needed to treat foreign sales of inventory among commonly controlled partnership-corporation groups the same as foreign sales among commonly controlled corporate groups.

BACKGROUND

Code section 267(a)(1) disallows losses on sales of property between certain related taxpayers. The Deficit Reduction Act of 1981 ("DEFRA") amended the section by (1) expanding the definition of related taxpayers to include controlled groups of corporations (using a 50 percent control test) and groups of partnerships and corporations where the same persons own more than 50 percent of the related entities (section 267(b)(3) and (10)); (2) adopting the consolidated return regulation approach for controlled groups of corporations, i.e., deferring losses until the property is transferred outside the group (section 267(f)(2)); and (3) providing that neither the loss deferral nor loss disallowance rule applies to sales of inventory in the ordinary course of business between a foreign corporation and a U.S. corporation where no tax avoidance motive is present (section 267(f)(3)(B)).

As a result, partnership/corporation groups are subject to full disallowance (rather than deferral) of losses on sales between group members; no exception exists for foreign sales of inventory in the ordinary course of business. The inventory exception for corporate groups was added by the DEFRA Conference Committee without explanation.

PROBLEM

Many related business groups include partnerships and corporations. The failure to exempt foreign sales of inventory among them is not explained and apparently was not intended.

For example, a domestic partnership and a related foreign corporation, both of which trade in securities, view the world as their market. They routinely sell each other securities at fair market value from their inventories in the ordinary course of their business and with no tax avoidance motive.

Absent the suggested technical correction to section 267, losses sustained by the domestic partnership on these sales to the commonly controlled foreign corporation would never be recognized, even though a real economic loss occurs. (Gains, however, would be recognized.) Thus, DEFRA unintentionally interferes with normal business activities of this and similar partnerships. They are at a competitive disadvantage as compared with corporations engaged in identical business activities.

It has been noted that section 122(c) of the Act would direct the Treasury to prescribe regulations applying the "matching principle" of paragraph (2) of subsection 267(a) when a payment is to be made to a foreign person. Because this proposed amendment is limited to the "matching principle" of paragraph (2), it has no effect on our problem. It arises under paragraph (1) of subsection 267(a), which disallows losses on sales of inventory in the ordinary course of business by a domestic partnership to a related foreign corporation.

PROPOSED SOLUTION

Foreign sales of inventory among partnership/corporation groups in the ordinary course of business should be treated in the same manner as sales among commonly controlled corporate groups, i.e., they should be exempt from section 267 where no tax avoidance motive is present. This can be accomplished by adding the following italicized text to the first portion of section 267(f)(3)(B): Except to the extent provided in regulations prescribed by the Secretary, subsection (a)(1) shall not apply to the sale or exchagne of property between members of the same controlled group, *or between a corporation and a partnership described in subsection (b)(10),* if—

I would welcome the opportunity to answer any question or to discuss this matter with you or your staff.

Respectfully submitted,

JERRY L. OPPENHEIMER.

MAYER, BROWN & PLATT,
Washington, DC, May 29, 1985.

Re Technical Corrections Act of 1985 (H.R. 1800)—Amendment to Code section 280F.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means, House of Representatives, Washington, DC.

DEAR MR. CHAIRMAN: This statement is submitted for the record of your May 16, 1985, hearing.

SUMMARY OF RECOMMENDATION

A technical correction to Code section 280F is needed to clarify that a net lease of aircraft is a qualified business use for investment tax credit ("ITC") and accelerated cost recovery deduction ("ACRS") purposes.

BACKGROUND

Section 280F was added by the Deficit Reduction Tax Act of 1984 ("DEFRA"). It provides that, (1) "listed property" will not qualify for the ITC or ACRS unless it is predominantly used in a "qualified business use" (section 280F(b)(1) and (2)); (2) "listed property" includes passenger automobiles; other property used as a means of transportation; property of a type generally used for entertainment, recreation, or amusement purposes; computers and peripheral equipment; and any other property specified by regulations (section 280F(d)(4)(A)); (3) "qualified business use" means "any use in a trade or business of the taxpayer" (section 280F(d)(6)(B)); and (4) property leased or held for leasing by a person "regularly engaged in the business of leasing" the property is not subject to these provisions (section 280F(c)(1)).

Section 280F(b) responds to the concern that "many taxpayers may be abusing the investment tax credit, the allowance for depreciation and the deductibility of business expenses by recharacterizing personal use of assets as business use". See S. Rep. No. 169, Vol. I, 98th Cong., 2nd Sess. 491 (1984).

The General Explanation of the Revenue Provisions of DEFRA prepared by the staff of the Joint Committee on Taxation (the "Blue Book"), at pages 559–60, further explains that ITC and ACRS "were designed to encourage investment in new plant and equipment rather than to subsidize the purchase of personal property that is used incidentally or occasionally in the taxpayer's business" and that, therefore, "Congress decided not to allow the incentive portion of tax benefits for property whose predominant use is personal or investment related".

PROBLEM

Taxpayers typically are lessors of major listed property, such as large aircraft, under extended net leases. Whether such taxpayers own the listed property directly, as co-owners, or as partners, it is not clear that they are "regularly engaged in the business of leasing" within the meaning of section 280F(C)(1) or "us[ing property] in a trade or business" within the meaning of section 280F(d)(6)(B). Such taxpayers rarely, if ever, use the property for personal purposes.

In this context, the potential for abuse at which section 280F(b) was aimed does not exist. Thus, ITC AND ACRS are not "subsidiz[ing] the purchase of personal property" which can be used by taxpayers for personal purposes. Nor is their use of such property "investment related"; such property is the investment.

To single out listed property such as aircraft for disallowance of ITC and ACRS discourages investments in and net leases of such listed property and favors investments in net leased property which is not "listed property". More specifically, it arbitrarily precludes an investor from net leasing aircraft and encourages investment in other types of property. This distortion and discrimination could not have been intended.

PROPOSED SOLUTION

Accordingly, section 280F(d)(6)(B) should be amended clearly to count for purposes of the "predominately used" test, use pursuant to a net lease to a person who uses the property in a trade or business. This would not exclude net leased property from section 280F(b); it would merely treat use under a net lease as any other business use and mitigate the bias against net leases of listed property. This may be accomplished by adding the following italicized text to the existing langauge of section 280F(d)(6)(B): Except as provided in Subparagraph (C), the term "qualified business use" means any use in a trade or business of the taxpayer or *by a taxpayer pursuant to a lease described in section 163(d)(4)(A) to a person who uses the property in a trade or business.*

I would welcome the opportunity to answer any question or to discuss this matter with you or your staff.

Respectfully submitted,

JERRY L. OPPENHEIMER.

MAYER, BROWN & PLATT,
Washington, DC, May 29, 1985.

Re Technical Corrections Act of 1985 (H.R. 1800)—amendment to Code section 1092.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means, House of Representatives, Washington, DC.

DEAR MR. CHAIRMAN: This statement is submitted for the record of your May 16, 1985, hearing.

SUMMARY OF RECOMMENDATION

A technical correction to Code section 1092 is needed to clarify that debt obligations do not have a short term holding period merely because they include inseparable puts.

BACKGROUND

Section 1092(b) gives the Treasury broad authority to issue regulations regarding gain or loss on positions which are a part of a straddle. The regulations are to apply the principles of section 1233(b) to the extent consistent with the purposes of section 1092. The section 1092(b) regulations are intended to prevent taxpayers from using straddles to convert short term into long term gain. Section 1233(b) is similarly designed to prevent converting short term into long term gain.

Under section 1233(b), the holding period of property which is "substantially identical" to other property sold short by the taxpayer does not commence until the short position is closed. The acquisition of an option to sell property at a fixed price, i.e., a put, is treated under section 1233(b) as a short sale by the option holder, and the exercise or failure to exercise a put closes the short sale.

Holding periods of properties not "substantially identical" are unaffected by section 1233(b). Consequently, section 1092(b) authorized Treasury to promulgate straddle holding period rules similar to, but broader than, the section 1233(b) rules by substituting "offsetting positions" for "substantially identical property". See S. Rep. No. 144, 97th Cong., 1st Sess. (1981) 149.

Taxable and tax exempt debt instruments commonly give holders rights at stated times to sell the obligations at par (or in the case of obligations issued at a discount at the issue price plus accrued discount) to the issuer, i.e., in effect one or more puts.

These inseparable put features are not abusive. Because the puts cannot be transferred separately from the instruments, they do not create the possibility of converting short term into long term gain or ordinary income to capital gain or of deferring income from one year to the next. Appropriately, these instruments and put features are not subject to section 1233(b), because section 1233(c) contains an exception for "married puts", i.e., puts acquired on the same day as the property to be used in exercising the put is acquired, and which, if exercised, are exercised through the sale of such property.

PROBLEM

Section 1092(b) makes no reference to 1233(c), and recently adopted temporary regulation § 1.1092(b)-2T(a)(1) provides that "the holding period of any position that is part of a straddle shall not begin earlier than the date the taxpayer no longer holds . . . an offsetting position with respect to that position".

If the debt and an inseparable put are viewed as offsetting positions under the regulation, the holding period of a debt obligation which contains an inseparable put may not begin until the put feature is terminated. Thus, the holding period of any holder of a debt obligation with an inseparable put would always be short term. This could not have been intended.

PROPOSED SOLUTION

It should be clarified that the section 1092 holding period rules do not apply to a debt instrument merely because of the existence of an inseparable put feature. This may be done by adding the following to section 1092(c)(2):

> (D) INSEPARABLE PUTS.—A provision in a debt instrument which provides that the holder may tender the instrument to the issuer for purchase does not constitute an offsetting position with respect to such debt instrument or to other debt instruments, when such provision is a right which cannot be disposed of or exercised by the holder of the debt instrument separately from a transfer of such debt instrument.

Alternatively, the following could be added to the end of section 1092(d)(2): "A provision in a debt instrument which provides that the holder may tender the instrument to the issuer for purchase does not constitute a position if such provision is a right which cannot be disposed of or exercised by the holder of the debt instrument separately from a transfer of the debt instrument."

I would welcome the opportunity to answer any question or discuss this matter with you or your staff.

Respectfully submitted,

JERRY L. OPPENHEIMER.

McCUTCHEN, DOYLE, BROWN & ENERSEN,
San Francisco, CA, May 30, 1985.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means, House of Representatives, Washington, DC.

DEAR MR. CHAIRMAN: The following comments are submitted for consideration by the Committee on Ways and Means with respect to H.R. 1800, the Technical Corrections Act of 1985. These comments suggest changes to Section 280G of the Internal Revenue Code dealing with excess parachute payments. Section 280G was enacted by the Tax Reform Act of 1984, Public Law 98-369.

SUMMARY

Section 280G dealing with excess parachute payments will affect many ordinary compensation arrangements and therefore will create unnecessary disputes. To avoid this, and thus aid the administration of the tax laws, section 280G needs technical changes.

"Reasonable compensation for services rendered" under section 280G should be clarified with respect to employment contracts, retirement plans, and stock options. Also, the mechanics of the statute should be changed so it is triggered only after first taking "reasonable compensation" out of the calculation.

A. SECTION 280G AFFECTS MANY ORDINARY COMPENSATION ARRANGEMENTS

If an executive receives "reasonable compensation for services rendered" on a change in control, there is no tax issue under section 280G. This rule works in theory but does not work well in practice because section 280G affects many ordinary compensation arrangements. Commonly, a terminated executive will receive payments from: a qualified pension plan, a qualified 401(k) plan, previously earned and voluntarily deferred salary or bonus, and post-retirement medical and life insurance benefits. There is no question that these amounts are "reasonable compensation for services rendered." Nevertheless, often these amounts alone will trigger section 280G, because when paid on change in control they are parachute payments and often total more than 3 times the base. After the statute is triggered, if any

other amount received is not reasonable compensation for services rendered, it is hit by nondeduction and an exercise tax.

This puts an extraordinary premium on what is "reasonable compensation for services rendered," and an agent has a double incentive (nondeduction and an excise tax) to challenge "reasonable compensation." In this context for the statute to be workable, and to avoid unnecessary disputes, there must be clear guidance on what is excluded reasonable compensation.

B. REASONABLE COMPENSATION—CLARIFICATION IS NEEDED

(1) *Payments after contract is terminated.*—If a new hostile board fires all the top executives but also pays them what they would have earned over the remaining term of their contracts, there is serious question whether this is reasonable compensation "for services rendered." Technically, no services will be rendered after termination. But the Joint Committee Blue Book says that payment for a covenant not to compete is for services "rendered," and the Congress should clarify that the same rule applies to the payment in settlement of a contract of employment. Otherwise, payment of an executive's basic livelihood will be subject to excise tax.

(2) *Retirement plans.*—The Blue Book recognizes as reasonable compensation payment under a supplemental retirement plan that compensates an executive for benefits lost on a move from a prior employer. But this is only part of the problem: an executive who is older and loses his job on a hostile takover may not be able to obtain a comparable job or may not be able to obtain retirement credit at his new job for prior service. Therefore, an employer must be able to protect its executives' retirement income. This is particularly the case for older employees who most need retirement benefits and often have a difficult time obtaining new employment. The Congress should make clear, therefore, that reasonable compensation for services rendered includes a supplemental retirement income that provides an employee what he would have received had he worked to normal retirement age and his employment not been prematurely terminated on a change in control.

(3) *Payments under pre-existing retirement plans.*—The "one year rule" of 280G(b)(2)(C) adds a presumption that payment under any amendment to a contract made within one year of change in control is contingent on change in control. It should be made clear, however, that any normal increase in compensation that creates an increase in retirement benefits under a plan's formula does not trigger the one year rule. This would be similar to the rule stated in the Blue Book that normal salary increases do not take a contract out of the grandfather rule.

(4) *Stock options.*—It is not clear whether stock options are valued at grant or at exercise. The Blue Book, however, states that the grant of stock options is a transfer of property to be valued at grant. The Congress should make it very clear that this rule governs. It may be quite difficult to establish "reasonable compensation for services rendered" for amounts received on exercise because the amount received often is based on market forces and not on the individual's service. An employee should not be deprived by an excise tax of the benefit of his stock option bargain because the market is favorable. (The Congress may wish to distinguish between options granted under an established program approved by shareholders well before any takeover and options that are granted in the course of takeover activity. The one year rule may accomplish this goal.)

C. REASONABLE COMPENSATION—THE MECHANICS DO NOT WORK RIGHT

Section 280G as now written is triggered when parachute payments, including reasonable compensation, are more than 3 times the base. Thereafter, parachute payments are reduced by reasonable compensation to determine if there are "excess" parachutes. If there is even $1 of parachute that is not reasonable compensation, nondeductibility and the exise tax apply. While "theoretically pure," this leaves no leeway for reasonable differences about reasonable compensation. This will lead to substantial litigation over reasonable compensation from publicly held companies, something previously avoided under the tax laws.

For proper administration, the statute must leave some leeway because the basic concept—"reasonable compensation"—is one over which reasonable people often differ. An easy way to do this is to eliminate "reasonable compensation for services rendered" from the definition of parachute payments. The statute then would be triggered only if parachute payments in excess of reasonable compensation ("real" golden parachutes) were more than 3 times the base. This would give room for some

disagreement over what is "reasonable" and would catch the people who are the real focus of the statute.

Respectfully submitted,

McCUTCHEN, DOYLE, BROWN & ENERSEN,
(By) ROBERT A. BLUM.

STATEMENT OF MATTHEW T. McGRATH, COUNSEL, MERRELL DOW PHARMACEUTICALS, INC.

This statement is submitted to the Committee on Ways and Means on behalf of Merrell Dow Pharmaceuticals Inc., in response to the invitation for comments on April 22, 1985 (Release #10) on H.R. 1800 (Technical Corrections Act of 1985) and H.R. 2110 (technical corrections to the Retirement Equity Act of 1984). In light of the chairman's hope "that individuals aware of additional technical problems not addressed in the bill will bring them to the Committee's attention", this statement is filed in order to identify such a technical problem arising under the Trade and Tariff Act of 1984, which was not addressed in H.R. 1800 at the time of its introduction, and which is hereby requested to be corrected by an amendment to H.R. 1800.

During the 98th Congress, a provision was included in the Trade and Tariff Act of 1984, P.L. No. 98-573, Section 154, which temporarily suspended the import duty on nicotine resin complex in the form of chewing gum pieces. This bill, introduced as H.R. 4224 by Congressman W. Henson Moore of Louisiana (a companion measure was introduced by Senator Lloyd Bentsen of Texas, S. 2334), was designed to provide for temporary duty-free entry of a trademarked substance imported by Merrell Dow Pharmaceuticals, Inc., known as Nicorette©, a chewing gum aid for terminating the smoking habit. The intent of Congress to provide such treatment for this product was clearly set forth in the reports of the Subcommittee on Trade of the Committee on Ways and Means (WMCP 98-34, 98th Cong. 2d Sess. 53 (1984) (attached as Exhibit A)), the Committee on Ways and Means (H. Rep. No. 98-1015, 98th Cong., 2d Sess. 46 (1984) (Exhibit B)), and the Senate Committee on Finance (S. Rep. No. 98-219, 98th Cong., 2d Sess. 17 (1984) (Exhibit C)).

At the time the tariff suspension was proposed in H.R. 4224, due to informal advices from the U.S. Customs Service, it was believed that Nicorette© would be classified upon entry into the customs territory of the United States as "Nicotine and its compounds," under item 437.13 of the Tariff Schedules of the United States. Consequently, the tariff suspension enacted in 1984 permitted duty-free entry of "nicotine resin complex (provided for in item 437.13, part 3B, schedule 4)." The U.S. Customs Service and other government agencies were asked to comment on the proposed suspension for Nicorette© chewing gum, and the Administration, including Customs, had no objection.

Since the tariff suspension was enacted, Customs' National Import Specialist was further consulted by the responsible port officials, and he concluded that Nicorette© should properly be classified under TSUS item 438.02, which covers nicotine compounds and all other products in subpart 3B of Schedule 4, "when imported in ampoules, capsules, jubes, lozenges, pills, tablets, troches, or similar forms, including powders put up in medicinal doses." As a result, the TSUS item referenced in the enacted duty suspension does not correspond with the TSUS item now applied by Customs to Nicorette©, and imports are being assessed a duty of 4% ad valorem, contrary to Congressional intent.

In order to effectuate the objective of Congress in passing Section 154 of P.L. No. 98-573, it is requested that a technical correction be made to the Trade and Tariff Act of 1984, revising the descriptive nomenclature of the enacted duty suspension to state as follows: "Nicotine resin complex put up in measured doses in chewing gum form (provided for in item 438.02, part 3B, schedule 4)." It is also requested that this correction be applied retroactively to the effective date of the Trade and Tariff Act of 1984: November 14, 1984. This correction would not necessitate any substantive change in the 1984 Act, and would merely correct the language of this measure in order to give effect to the stated purpose of the statute. Because of the purely corrective nature of this proposal, it is an appropriate subject for inclusion in H.R. 1800. Title II, Part C of H.R. 1800 incorporates similar corrections to the appendix to the TSUS. (See, e.g., Sections 221(2) (A), (B), and (C)). It should also be added to the Senate Technical Corrections Act of 1985, S. 814.

The U.S. Customs Service, Office of Regulations and Rulings, Classification and Value Division, has recently examined the above-described proposed change, and it is understood that customs does not object to the corrected language. Customs has also re-confirmed the present classification of Nicorette© under TSUS 438.02, requir-

ing that this correction be made in order to implement the suspension intended by the 1984 Act.

Therefore, in order to give effect to Section 154 of the Trade and Tariff Act of 1984, as clearly stated by Congress, and since the Customs Service has agreed on the appropriate technical method and tariff nomenclature to accomplish this purpose, it is requested that the attached amendment be incorporated into the Technical Corrections Act of 1985.

PROPOSED AMENDMENT TO H.R. 1800

(a) That Section 221 be amended by adding a new subsection (2)(D), as follows:

"(D) The article description for item 907.63 is amended to read as follows: "Nicotine resin complex put up in measured doses in chewing gum form (provided for in item 438.02, part 3B, Schedule 4)."

(b) That Section 221 be further amended by adding a new subsection (4) as follows:

"(4) EFFECTIVE DATE OF CORRECTIONS.—Notwithstanding section 514 of the Tariff Act of 1930 or any other provision of law, upon proper request filed with the customs officer concerned on or before the 90th day after the date of the enactment of this Act, the entry of any article described in section 221(2)(D) of this Act,

"(1) which was made after November 14, 1984 and before the 15th day after the date of enactment of this Act; and

"(2) with respect to which there would have been no duty if the amendment made by section 221(2)(D) applied to such entry—

shall be liquidated or reliquidated as though such entry had been made on the 15th day after the date of enactment of this Act".

EXHIBIT A

98th Congress
2d Session

COMMITTEE PRINT

WMCP: 98-34

SUBCOMMITTEE ON TRADE

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

REPORT

ON

MISCELLANEOUS TARIFF AND CUSTOMS BILLS

JULY 25, 1984

U.S. GOVERNMENT PRINTING OFFICE
WASHINGTON : 1984

36-895 O

H.R. 4224

Introduced by: Mr. Moore (LA)
Date: October 26, 1983

To suspend for a three year period the duty on nicotine resin complex.

Summary of the Provision

H.R. 4224, if enacted, would suspend until September 30, 1987 the duty on nicotine resin complex, commonly called nicorette.

Section-by-Section Analysis

Section 1 of H.R. 4224, if enacted, would amend subpart B of part 1 of the Appendix to the Tariff Schedules of the United States (19 U.S.C. 1202) by inserting in numerical sequence a new item TSUS 907.73 to suspend the column 1, MFN, duty until September 30, 1987 on a nicotine resin complex, provided for in item 437.13, part 3B, schedule 4.

Section 2 makes the provision effective on or after the 15th day after the date of the enactment of this Act.

Background and Justification

Nicorette is a product to be used as an aid for terminating the smoking habit. Assuming the FDA approves this drug, it will be available by prescription only. Merrell Dow Pharmaceuticals Inc. has filed a petition for approval with the U.S. Food and Drug Administration. The approval has not been granted as of yet. If the approval is obtained, the way will be cleared to market the product in the U.S. The product is being marketed in Canada and in European countries. The product is covered under composition patents owned by Aktiebolaget Leo, a Swedish corporation.

Comparison With Present Law

Nicorette is classifiable under TSUS item 437.13 as a compound of nicotine. The current column 1 rate of duty is 4.4 percent ad valorem. The column 2 rate of duty is 25% ad valorem.

This item is eligible for staged rate reductions under the Tokyo round of the MTN and the column 1, MFN, rate of duty will be reduced to 3.7% by January 1, 1987.

Imports from designated beneficiary developing countries under TSUS item number 437.13 are eligible for duty-free treatment under

the Generalized System of Preferences (GSP). The LDDC rate of duty is 3.7% ad valorem.

Effect on Revenue

It is estimated that the annual future loss of revenue as a result of enactment of this legislation would be about $220,000 in 1983, declining in ensuing years as a result of staged rate reductions unless import levels increase.

Subcommittee Action

Agency Reports

The Department of Commerce has no objection to enactment of H.R. 4224.

The International Trade Commission submitted an informative report.

Markup

On June 27, 1984, the Subcommittee on Trade ordered H.R. 4224 favorably reported to the full Committee on Ways and Means by voice vote, with technical amendments, including changes in the article description and in the effective date to make it effective 15 days after date of enactment and to have the provision expire on a date certain.

Senate Action

A companion bill (S. 2334) was introduced by Senator Bentsen.

SUMMARY OF TESTIMONY ON H.R. 4224

Administration

Department of Commerce: No objection to enactment.

49-704 1269

H.R.

Introduced by: Mr. Moore (LA)
Date: October 26, [illegible]

To suspend the duty on [illegible]

Summary of the Provision

H.R. 4225, if enacted, [illegible] the duty on an iron dextran [illegible]

Section-by-Section Analysis

Section 1 of H.R. 4225, [illegible] of part 1 of the Appendix [illegible] States (19 U.S.C. 1202) by [illegible] item to suspend the colum[illegible] on iron dextran complex, [illegible] 3C, schedule 4.

Section 2 makes the [illegible] day after the date of the [illegible]

Background and Justification

According to an impor[illegible] Cincinnati, Ohio, the pro[illegible] in the world. It is a li[illegible] and 2-ml. ampoules.

Iron dextran complex [illegible] deficiency anemia.

Comparison with Present Law

Iron dextran is class[illegible] imported in ampoules, cap[illegible] in medicinal doses. The [illegible] percent ad valorem. The [illegible] valorem.

This item is eligible [illegible] Tokyo round of the MTN and [illegible] be reduced to 3.7 percent [illegible]

Imports from designat[illegible] under TSUS item number 44[illegible] under the Generalized Sys[illegible] of duty is 3.7 percent ad [illegible]

36-895 O - 84 - 2

EXHIBIT B

98TH CONGRESS 2d Session | HOUSE OF REPRESENTATIVES | REPORT 98-1015

MISCELLANEOUS TARIFF AND CUSTOMS AMENDMENTS

SEPTEMBER 13, 1984.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

Mr. ROSTENKOWSKI, from the Committee on Ways and Means, submitted the following

REPORT

[To accompany H.R. 6064]

[Including cost estimate of the Congressional Budget Office]

The Committee on Ways and Means, to whom was referred the bill (H.R. 6064) to change the tariff treatment with respect to certain articles, and for other purposes, having considered the same, report favorably thereon with amendments and recommend that the bill as amended do pass.

The amendments are shown in the reported bill, with the matter proposed to be stricken shown in linetype and the matter proposed to be inserted shown in italic type.

SUMMARY OF PROVISIONS

H.R. 6064 is a bill which incorporates 62 noncontroversial tariff and trade bills, approved by the Committee on Ways and Means. They involve permanent duty free entry, temporary duty reductions, temporary suspensions of duties, certain classification changes and other actions. The committee has combined these bills into a single omnibus bill to facilitate their consideration by the House of Representatives.

Section 101 applies to all other sections of the bill. It states that whenever an amendment or repeal is expressed in terms of an amendment to, or repeal of, a schedule, item, headnote or other provision, the reference shall be considered to be made to a schedule, item, headnote, or other provision of the Tariff Schedules of the United States (19 U.S.C. 1202).

Section 111 contains a provision introduced by Mr. Frenzel, H.R. 4255, to provide for a reduction in duty on certain fresh or chilled

81-006 O

United Kingdom and are marketing that product in the United States.

Data concerning U.S. production of 5-chloro-2-methyl-4-isothiazolin-3-one and 2-methyl-4-isothiazolin-3-one, magnesium chloride and magnesium nitrate are not available.

Data on U.S. imports of the mixtures of 5-chloro-2-methyl-4-isothiazolin-3-one and 2-methyl-4-isothiazolin-3-one, magnesium chloride, and magnesium nitrate are included within the statistical classification for other mixtures, not specially provided for. Therefore, data on this product alone are not available. The Committee understands that it is the intention of the patent holder, Rohm and Haas, to supply the U.S. market for this product with imports only, rather than to produce the product in the U.S.

Data on U.S. exports of the mixtures in question are included within the export classification for mixtures and preparations, not specially provided for, and, therefore, data on this product alone are not available.

U.S. consumption of this product is believed to be approximately equal to the amount imported.

Mixtures of isothiazolinones are classified in TSUS item 432.25 as other mixtures not specially provided for, at a column 1 rate of duty of 4.2 percent ad valorem, but not less than the highest rate applicable to any component material. The LDDC and column 2 rates are, respectively, 3.7 percent and 25 percent ad valorem, but not less than the highest rate applicable to any component material. Articles imported from designated beneficiary countries and classified under TSUS item 432.25 are eligible for duty-free treatment under the Generalized System of Preferences (GSP). Imports from designated beneficiary Caribbean Basin countries are eligible for duty-free entry under the Caribbean Basin Initiative (CBI).

The component material contained in this mixture which has the highest rate of duty if imported as an individual compound is either one of the isothiazolinone compounds. Isothiazolinones are nitrogenous compounds classified under item 425.52, at a column 1 rate of duty of 7.9 percent ad valorem, and a column 2 rate of 30.5 percent ad valorem. The concession granted with respect to item 425.52 during the Tokyo round of the Multilateral Trade Negotiations provided for a one-time reduction on July 1, 1980, from 8.4 percent to 7.9 percent ad valorem.

Section 154. Nicotine Resin

(Originally introduced as H.R. 4224 by Mr. Moore)

Section 154 would amend subpart B of part 1 of the Appendix to the TSUS by inserting in a new item TSUS 907.63 to suspend the column 1, MFN, duty until September 30, 1987 on nicotine resin complex, provided for in item 437.13, part 3B, schedule 4.

Nicotine resin complex, commonly known as nicorette, is a product to be used as an aid for terminating the smoking habit. Assuming the FDA approves this drug, it will be available by prescription only. Merrell Dow Pharmaceuticals Inc. Has filed a petition for approval with the U.S. Food and Drug Administration. The approval has not been granted as of yet. If the approval is obtained, the way

will be cleared to market the product in the U.S. The product is being marketed in Canada and in European countries. The product is covered under composition patents owned by Atkiebolaget Leo, a Swedish corporation.

Nicorette is classifiable under TSUS item 437.13 as a compound of nicotine. The current column 1 rate of duty is 4.2 percent ad valorem. The column 2 rate of duty is 25% ad valorem.

This item is eligible for staged rate reductions under the Tokyo round of the MTN and the column 1, MFN, rate of duty will be reduced to 3.7% by January 1, 1987.

Imports from designated beneficiary developing countries under TSUS item number 437.13 are eligible for duty-free treatment under the Generalized System of Preferences (GSP). The LDDC rate of duty is 3.7% ad valorem.

SECTION 155. RIFAMPIN

(Originally introduced as H.R. 3742 by Mr. Albosta)

Section 155 would amend subpart B of part 1 of the Appendix to the TSUS by inserting a new item 906.99 to suspend the column 1, MFN, duty until the close of September 30, 1987 on rifampin, provided for in item 437.32, part 3B, schedule 4.

Rifampin is an active ingredient used in the manufacture of the prescription drug sold under the trademarks Rifadin and Rifamate. The product is an antibiotic. The chemical name for rifampin is hydrazone, 3-(4-methylpiperazinyliminomethyl) rifamycin SV.

Rifampin is classifiable under TSUS item 437.32 with a column 1 rate of duty of 4.2 percent ad valorem. The column 2 rate of duty is 25% ad valorem.

This item is eligible for staged rate reductions under the Tokyo round of the MTN and the column 1, MFN, rate of duty will be reduced to 3.7% in 1987.

Imports from designated beneficiary developing countries under TSUS item number 437.32 are eligible for duty-free treatment under the Generalized System of Preferences (GSP). The LDDC rate of duty is 3.7% ad valorem.

SECTION 156. LACTULOSE

(Originally introduced as H.R. 4223 by Mr. Moore)

Section 156 would amend subpart B of part 1 of the Appendix to the TSUS by inserting a new item TSUS 907.76 to suspend the column 1, MFN, duty until September 30, 1987 on lactulose, provided for in item 439.50, part 3C of schedule 4.

Lactulose is an active ingredient used in the manufacture of the prescription drug sold under the trademarks Cephulac and Chronulac. These products are laxatives. The chemical name for lactulose is 4-0-beta-D-galactopyranosyl-D-fructose.

Lactulose is classifiable under TSUS item 439.50 under the classification of "Other Drugs". The current column 1 rate of duty is 3.7 percent ad valorem. The column 2 rate of duty is 25% ad valorem.

This item is not eligible for staged rate reductions under the Tokyo round of the MTN.

EXHIBIT C

98th Congress
2d Session | COMMITTEE PRINT | S. PRT.
93-219

OMNIBUS TARIFF AND TRADE MEASURES

EXPLANATION OF PROVISIONS APPROVED BY THE COMMITTEE ON JULY 31, 1984

TO BE OFFERED AS A COMMITTEE AMENDMENT TO H.R. 3398

COMMITTEE ON FINANCE

UNITED STATES SENATE

AUGUST 1984

regular-size fabric looms that can also be used on narrow fabric looms. 1983 imports of narrow fabric looms were 440 units valued at $3.9 million.

SECTION 174—NICOTINE RESIN COMPLEX

Section 174 would suspend through June 30, 1987 the duty on nicotine resin complex.

Current law.—Nicotine resin complex is classified under TSUS item 437.13 as an alkaloid compound based on nicotine. The MFN rate of duty is 4.2 percent ad valorem. The non-MFN rate of duty is 25 percent ad valorem. The LDDC rate is 3.7 percent ad valorem.

Articles imported from designated beneficiary developing countries and classified under TSUS item 437.13 are eligible for duty-free entry under the GSP. Imports from designated Caribbean countries are eligible for duty-free treatment under the CBI.

The bill.—Section 174 would amend the Appendix to the TSUS to suspend through June 30, 1987 the MFN rate of duty on nicotine resin complex.

Background.—The trade name of this product is Nicorette. Nicorette is a prescription chewing gum that has been available for purchase in the United States since March 1984, following FDA approval. Nicorette has been sold for more than five years in Europe and for nearly that long in Canada. When chewed, it releases a small amount of nicotine which is much less than that produced by smoking. It is intended to help smokers who want to wean themselves from the habit of smoking. There is no domestic producer of this product.

SECTION 175—TARTARIC ACID AND CERTAIN TARTARIC CHEMICALS

Section 175 would through until June 30, 1988, a temporary duty suspension for certain tartaric chemicals that expired June 30, 1984.

Current law.—Tartaric acid is classified under TSUS item 425.94 with a MFN duty rate of 5.1 percent of ad valorem, an LDDC rate of 4.3 percent ad valorem, and a non-MFN duty rate of 17 percent ad valorem. Tarter emetic is classified under TSUS item 426.72, with a MFN duty rate of 1.9 percent ad valorem, an LDDC rate of 1.8 percent ad valorem, and a non-MFN duty rate of 4 percent ad valorem. Cream of tartar is classified under TSUS item 426.76 with a MFN duty rate of 5.5 percent ad valorem, an LDDC rate of 4.6 percent ad valorem, and a MFN duty rate of 11 percent ad valorem. Rochelle salt is classified under TSUS item 426.82 with a MFN duty rate of 4.7 percent ad valorem, an LDDC rate of 4.1 percent ad valorem, and a non-MFN duty rate of 11.5 percent ad valorem. The MFN rates are being staged down through 1987.

Imports under all four of the above tariff provisions, if from designated beneficiary countries, are eligible for duty-free entry under the GSP and CBI.

The bill.—Section 175 would amend items 907.65 (tartaric acid), 907.66 (potassium salts), 907.68 (cream of tartar), and 907.69 (sodium tartrate (Rochelle Salts)) of the Appendix to the Tariff Schedules of the United States (TSUS) to extend the temporary

MORGAN, LEWIS & BOCKIUS,
Philadelphia, PA, May 15, 1985.

Re Technical Corrections Act of 1985—section 102(a)(2) of the bill and section 168(j)(4)(E) of the Code.

JOSEPH K. DOWLEY, Esq.,
Chief Counsel, House Ways and Means Committee, Washington, DC.

DEAR MR. DOWLEY: I am writing this letter to you on behalf of a client to point out what may be an unintended result of Section 102(a)(2) of the Bill (amending Section 168(j)(4)(E) of the Code), and if the result is in fact intended, to point out to you that it represents a substantive change that should be given a prospective effective date.

I. HYPOTHETICAL FACTS

Hospital ("H") owns a parking lot (the "Old Lot") and a medical office building (the "Old Building"). The Old Lot is inadequate to hold all of the staff, patient and visitor automobiles. The Old Building, which is leased by H to physicians, is in violation of local building codes and must be replaced.

In October, 1984, after enactment of the Tax Reform Act of 1984, the following transactions were consummated. H formed a wholly-owned, for-profit subsidiary ("S"). S, an unrelated for-profit corporation ("C"), and an investor group ("IG") formed a limited partnership (the "Partnership") to construct and operate a new parking lot ("New Lot") and a new medical office building ("New Building"). S and C are co-general partners and IG is the limited partner. The sharing ratios for profits and losses are 99% to IG (the limited partner) and 0.5% each to S and C (the general partners) until IG receives cash distributions equal to its initial capital contribution of $3.0 million. Thereafter, the sharing ratios "flip" to 60% to IG (the limited partner) and 20% each to S and C (the general partners). The New Lot will be operated by the Partnership and may be used by anyone who pays the daily parking fee. The New Building will be operated by the Partnership and leased to physicians. Construction on the New Parking Lot and New Building commenced in November, 1984.

II. PRESENT LAW

Under present law, Section 168(j)(4)(E)(i) reads as follows: "For purposes of this subsection . . . an organization shall be treated as [a tax-exempt entity] with respect to any property *of which such organization is the lessee* if such organization was an organization . . . exempt from tax imposed by this chapter at any time during the 5-year period ending on the date such property was *first leased* to such organization (emphasis added)."

Under present law, it is clear that the Partnership does not have a tax-exempt entity leasing problem, because S is not a tax-exempt entity within the meaning of Section 168(j)(4) for purposes of applying Section 168(j)(9). Specifically, S is not a tax-exempt entity within the meaning of Section 168(j)(4)(E)(i) because neither S nor the Partnership is the lessee of any property (even if S is assumed to be a successor organization to H within the meaning of Section 168(j)(4)(E)(iii) by reason of H's activities in connection with the Old Lot and the Old Building).

III. TECHNICAL CORRECTION

Under Section 102(a)(2) of the Bill, Section 168(j)(4)(E)(i) is amended to read as follows: "For purposes of this subsection . . . an organization shall be treated as [a tax-exempt entity] with respect to any property *(other than property held by such organization)* if such organization was an organization . . . exempt from tax imposed by this chapter at any time during the 5-year period ending on the date such property was *first used* by such organization (emphasis added)."

Under the Bill, the rule for former tax-exempt organizations and their successors is no longer limited to property that is leased to such organizations; the rule applies with respect to any property used by such organizations other than property owned by a former tax-exempt entity or a successor organization.

In the hypothetical set forth above, a tax-exempt entity leasing problem is created. By reason of H's activities in connection with the Old Lot and the Old Building, S is assumed to be a successor organization within the meaning of Section 168(j)(4)(E)(iii). Next, S is apparently treated as a tax-exempt entity with respect to the New Lot and the New Building by reason of Section 168(j)(4)(E)(i), even though the lot is "used" by the Partnership. (The explanation prepared by the Joint Com-

mittee on Taxation provides that property is treated as first used by an organization in the case of property owned by a partnership of which the organization is a member on the later of (i) the day on which the property is first used by the partnership or (ii) the day on which the organization is first a member of the partnership.) Accordingly, the New Lot and New Building apparently would be treated as tax-exempt use property to the extent of 20% under Section 168(j)(9).

IV. COMMENT

In the hypothetical, only taxable entities are partners in a partnership which leases property only to other taxable entities (the physicians). Yet the property apparently is subject to the tax-exempt entity leasing rules. This is a rather startling result, since no potential tax avoidance is present in such a transaction. Whatever problem the Bill is designed to solve, it seems clear that the solution goes beyond any potential abuse involving tax-exempt entity leasing.

Even if this change is enacted, it would amount to a sweeping substantive change and not a technical correction. Taxpayers should not have the tax consequences of an already completed transaction changed under the guise of a technical correction. At a minimum, therefore, this change should not apply with respect to the application of Section 168(j)(9) to property that a partnership either owned as of March 28, 1985 (the date the Bill was introduced into the House) or was under a binding contract to acquire or construct as of March 28, 1985 (see § 31(g)(3)(B) of the Tax Reform Act of 1984).

Very truly yours,

ROBERT D. COMFORT.

STATEMENT OF NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS, INC.

I. EXCLUSION FROM THE REIT DISTRIBUTION REQUIREMENT FOR NONCASH INCOME RECOGNIZED BY A REIT UNDER CERTAIN DEFERRED PAYMENT AND INSTALLMENT SALES RULES ADDED BY THE TAX REFORM ACT OF 1984

The Tax Reform Act of 1984 (1984 Act) amended the Internal Revenue Code (Code) to alter the tax consequences of many transactions involving loans or leases that allow deferred payment of interest or rents. The 1984 Act also revised the tax treatment of installment sales of property subject to depreciation recapture. In each case, the new rules may cause a taxpayer to recognize and pay tax on income when no corresponding amount of cash has been received.

Because a REIT must distribute 95 percent of its income as dividends to shareholders, the new rules cause uniquely and exceptionally harsh results that we believe were unintended. To reconcile the special REIT tax provisions with the 1984 Act provisions, the National Association of Real Estate Investment Trusts (NAREIT) recommends that the Act be amended to provide that any noncash amounts included in REIT taxable income by operation of the 1984 Act be disregarded for purposes of the 95-percent distribution requirement. As undistributed income, those amounts will thus be subject to taxation, at corporate rates, at the REIT level.

Deferred payment of interest

The 1984 Act added new Code sections 1273 and 1274 and made other amendments to the Code in order to extend original issue discount (OID) concepts to various debt obligations including those issued in nontradable form in exchange for an interest in property that is not publicly traded. Under prior law, a cash method real estate lender and an accrual basis borrower could sometimes structure agreements to allow for deferred payment of interest due with the result that interest expense deductions could be claimed currently while tax on the corresponding interest income was postponed until actual receipt. The expanded OID provisions, through their mandate for periodic inclusion and deduction of interest, now limit such mismatching of income and deduction in the real estate context.

Deferred payment of rent

Congress identified similar mismatching problems in the real estate leasing context where an accrual basis lessee was allowed to defer payment of all or part of rent payable for the use of property owned by a cash basis lessor. Section 92 of the 1984 Act added new Code section 467 to prescribe that rents (and any associated interest) attributable to a deferred rent arrangement be reported as income and deducted by the lessee as if both parties employed the accrual method for tax account-

ing purposes. This general rule is subject to certain safe harbors and other modifications to take into account commercially reasonable "stepped" or escalating rents.

Installment sales and recapture income

Section 112 of the 1984 Act modified the installment sale provisions of the Code to provide that, irrespective of sales proceeds actually received, a seller must include in income in the year of sale all recapturable depreciation with respect to a property sold on an installment basis. Legislative history indicates concern that the installment sale provisions of the Code have unduly eroded the force of the recapture rule as a mechanism to limit "churning," that is, the disposal of property when depreciation and other tax benefits are exhausted. Despite arguments that taxpayers should not be taxed on gains until cash to pay the tax is actually received, the new recapture concept was adopted on the grounds that each seller had enjoyed the benefits of depreciation prior to the year of sale.

Tax consequences for REITs and other taxpayers

In each case, the provisions added by the 1984 Act may give rise to situations in which taxpayers must recognize income when little or no cash is received. Although the new rules are intended to provide substantial disincentives to the prescribed deferred payment and installment sale transactions, there may be circumstances in which taxpayers are compelled to enter into such arrangements. If a REIT is a lender, lessor, or seller under these circumstances, the consequences are uniquely and unjustifiably harsh.

A nonREIT taxpayer with taxable income in excess of cash receipts must accumulate sufficient funds to pay tax at the marginal rate applicable to that taxpayer. In the case of an individual earning the income directly or as his share of the partnership income, the highest marginal rate is typically 50 percent. For a corporation, it is 46 percent.

In contrast, a REIT may have to accumulate cash in an amount virtually equal to the noncash income. This effort is made necessary, and more difficult, by the fact that at REIT must distribute 95 percent of its taxable earnings to shareholders in order to remain qualified. Under these circumstances, the REIT may be compelled to borrow money or liquidate assets to satisfy the distribution requirement.

The dilemma for the REIT is made more acute because of the implications of disqualification. Failure to make a sufficient distribution may subject the REIT to taxation at corporate rates on its income for the current year even though most or all of that income had already been distributed. It might prevent the REIT from qualifying in subsequent years. Although the deficiency dividend procedures of section 860 may alleviate these burdens somewhat, the prospect of disqualification remains an immense deterrent. It is unfair that the REIT, a vehicle already subject to extensive operating constraints, should thus be disproportionately deprived of the flexibility to enter into deferred payment sales, to select accelerated depreciation, or to undertake installment sales whenever circumstances dictate such practices.[1]

It is our belief that these consequences reflect an oversight in the process of drafting the complex imputed income and depreciation recapture provisions of the 1984 Act. Accordingly, we believe the Technical Corrections Act of 1985 provides the appropriate context in which to reconcile those provisions with the specialized rules governing REITs.

Proposed relief

To afford REITs modest additional flexibility and tax treatment more nearly comparable to that of other taxpayers, NAREIT proposes that the REIT distribution requirement be made inapplicable to noncash income recognized by a REIT pursuant to the new deferred payment and installment sale recapture rules. Specifically, NAREIT recommends that the minimum REIT dividends paid deduction prescribed in section 857(a)(1) be adjusted so that REIT taxable income shall exclude amounts otherwise added to income by reason of sections 453(i), 467, 1273 and 1274(c) of the Code to the extent such amounts exceed actual payments received by the REIT pursuant to transactions to which these sections apply. Thus, the noncash portion of taxable income would be subject to taxation at corporate rates at the REIT level, thereby reducing the amount of cash that the REIT must accumulate from other sources to not more than 46 percent of the noncash taxable income.

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[1] These consequences are particularly anomalous in the installment sale recapture context, because the benefits of accelerated depreciation are substantially limited for REITs and their shareholder by operation of the earnings and profits rules applicable to REITs.

II. CLARIFICATION OF THE RULES FOR WITHHOLDING ON DISTRIBUTIONS OF REIT CAPITAL GAINS TO FOREIGN SHAREHOLDERS

Section 129 of the 1984 Act added Code section 1445 to provide withholding rules to enforce the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA). The new provisions include various requirements for withholding on distributions and transfers by domestic corporations, partnerships, trusts and estates with foreign investors or beneficiaries.

Neither the legislation nor the accompanying committee reports address withholding by REITs. The only evidence of a withholding requirement for REITs appears in a terse statement in the General Explanation of the 1984 Act prepared by the staff of the Joint Committee on Taxation. No guidance is provided on how properly to impose withholding.

NAREIT believes that the omission of specific REIT provisions, particularly as withholding on dividend distributions, may present sufficiently serious issues and problems to warrant corrective legislation. We accordingly urge the Committee to add such legislation to the technical corrections bill now under consideration.

Taxation of REIT distributions and transfers under FIRPTA

Any distribution of money by a REIT to nonresident aliens is taxable under FIRPTA to the extent "attributable to" gains realized by the REIT from sale or exchange of U.S. real property interests. (I.R.C. section 897(h)(1)). The report of the Ways and Means Committee for FIRPTA indicates that net capital gain of the REIT is the basis for determining the tax liability of a foreign distributee. (H.R. Rep. No. 96-1479, 96th Cong., 2nd Sess. 188 (1980)). As to cash distributions out of a REIT's ordinary income, no tax is payable under FIRPTA, but foreign shareholders are subject to the 30 percent withholding tax (sometimes reduced by treaty) imposed on corporate dividends under 1441 of the Code.

In the case of an in-kind distribution of U.S. real property by a REIT, a tax is imposed on the REIT under FIRPTA to the extent of the foreign ownership percentage. Carryover basis rules apply if a foreign controlled REIT distributes property to its shareholders.

Withholding on distributions by REITs and other entities

New Code section 1445(e) provides special rules for withholding by entities that control U.S. real property. These special rules are provided for U.S. partnerships, trusts and estates that dispose of U.S. property or make taxable distributions to partners or beneficiaries, U.S. corporations making certain distributions to shareholders, and foreign entities carrying out similar activities. In general, the managers or fiduciaries of the entities bear the responsibility of withholding whenever a gain taxable to a foreigner is likely to be triggered under FIRPTA, but several exceptions apply.

As noted above, the Joint Committee staff's General Explanation includes the only reference to REITs in the context of the new withholding rules. The explanation states merely that "[d]istributions to foreign persons by a real estate investment trust (REIT) that are attributable to gains from the disposition of U.S. real property interests are subject to withholding under the Act."

In its proposed and temporary regulations issued in December, 1984, the Internal Revenue Service has attempted to address withholding by REITs, both with respect to distributions attributable to gains on disposition of REIT property and on distributions of property to shareholders. Although the proposed regulations make a significant contribution, we believe they vividly illustrate the need for legislative clarification of REIT treatment under section 1445. For example, written within a framework of rules for partnerships, trusts and corporations, the regulations reach disparate results for in-kind or redemptive property distributions depending upon whether a REIT is organized as a business trust or corporation. Furthermore, in addressing the critical question of withholding on dividend distributions attributable to sales of property by a REIT, the IRS was effectively compelled to analogize to the partnership and trust provisions of section 1445(e)(1). Although the analogy to these tax conduits is somewhat appropriate, it simply cannot serve to harmonize the corporate and other operational attributes of REITs with the statutory and regulatory treatment of those entities.

FIRPTA withholding and REIT organizational and operational attributes

In order to qualify for its special tax treatment, a REIT must be a corporation or a trust or association taxable as a corporation. The special tax treatment takes the form of a dividends paid deduction against taxable income computed generally as if

a REIT were a corporation, and REITs are routinely characterized as corporations for other purposes under the Code.

Consistent with Congressional objective in enacting the REIT provisions, REIT securities generally are widely held and freely transferable. According to information compiled by NAREIT, most REITs have shareholders of record numbering in excess of 1,000 with many REITs counting from 5,000 to 15,000 investors. The securities of some 40 REITs are listed on the New York or American Stock Exchanges, and another 40 REITs are traded in the over-the-counter market.

Significantly, nominees or other intermediaries play a substantial role in the ownership and trading of REIT securities. It is our understanding that a REIT may often find that 30 to 40 percent and sometimes much more of its shares are held in "street name" or in some other form of nominee ownership.

With respect to dividend payment practices, REITs typically make periodic distributions of operating income (rental and mortgage interest) to shareholders. As a general rule, these distributions are made quarterly, but some REITs maintain a monthly dividend payment schedule.

Under Code Section 857(b)(3), a REIT may also distribute capital gain to shareholders, to be taxed as such in the hands of the shareholder, provided the capital gain dividend does not exceed the net capital gain of the REIT and provided the distribution is designated as capital gain in a notice mailed to shareholders not later than 30 days after the close of the REIT taxable year. To conform to these rules, REITs typically pay any capital gain dividends shortly after the year end under procedures provided by section 858. Undistributed capital gain is taxed to the REIT at the rate generally applicable to corporations.

These and other considerations raise important issues in the development of a workable system of withholding for distributions of REIT capital gain. In particular, the number of REIT shareholders, the trading in REIT securities and the number of periodic distributions by REITs may combine to present serious problems in identifying shareholders for whom withholding is required. For partnerships and trusts, whose interests are generally illiquid and which make less frequent distributions, there is ordinarily little concern that withholding will be imposed on the wrong beneficial owner. Moreover, the nonforeign certification procedures provided by section 1445 generally may be administered effectively and at relatively modest cost.

Such is not the case for the publicly-traded REIT, and there is the threat of inappropriate withholding imposed on foreigners who buy or sell stock shortly before a distribution. There is also the prospect that, because a REIT may be compelled to withhold in the absence of certification of nonforeign status, withholding will be imposed on domestic shareholders.

It is also noteworthy that, absent clarification, the withholding rules may be inconsistent with the way REIT dividends are treated under section 857, again with the prospect of overwithholding. As noted earlier, the substantive FIRPTA provision in section 897(h) is intended to reach only net capital gain dividends. Without specific statutory guidance under section 1445, the question will continue to arise as to which distributions from the REIT will trigger withholding.

Proposed relief

To clarify the treatment of REITs under section 1445, NAREIT urges the Committee to amend that section to address at least two fundamental concerns. First, we recommend that section 1445 make clear that FIRPTA withholding apply only with respect to capital gain dividends paid pursuant to Code section 857(b)(3)(C), accompanied if necessary by a clarification of the latter section to assure that any REIT distributing capital gain prior to the end of the taxable year does so only upon making the necessary designation. Second, we believe section 1445 should allow a REIT to forgo withholding on payments to recipients having U.S. addresses, while causing any recipients who are not beneficial owners, such as nominees, to assume the withholding obligation if the beneficial owner fails to deliver the prescribed certification of nonforeign status.

STATEMENT OF NEAL F. ZIMMERS, JR., OHIO STATE SENATE, ON BEHALF OF THE NATIONAL CONFERENCE OF STATE LEGISLATURES

Mr. Chairman, Members of the Committee: my name is Neal F. Zimmers, Jr., and I am Assistant Minority Leader in the Ohio Senate. I am here today on behalf of the Ohio Senate and the National Conference of State Legislatures, which has adopted a formal policy on the issue of the temporary authority of the governor in the allocation of the recently established cap on each state's volume of industrial development bonds. I don't hesitate to say that NCSL is also opposed to these

volume caps as a means of restricting the use of the bonds, but that is not the subject of my statement here today.

In fact, I'm here to say that as I read the provisions relating to the ability of states to develop alternative allocations under the cap, I am encouraged by the Congress' understanding of the balance and separation of powers in the states and your willingness to leave the decision-making up to the usual laws, procedures and practices of each state. A change does need to be made in the number of session days (60) which trigger the sunset of the governor's temporary authority. Several states do not have 60 session days in a regular session, and thus the number raises concern over the status of the governor's allocation today in those states.

State legislators do not wish to encourage you to give us more work to do in our sessions. In its own way, this can be preemptive of state matters of equal or greater importance. However, we are more opposed to outright preemption by having powers granted to governors rather than states. That was not your intention here, although the reason I am before you is that the Treasury Department, in its wisdom, has interpreted this section of the Act to bias the development of state allocations in favor of governors over legislatures.

On this topic, the statute reads as follows (emphasis added):

"(6) STATE MAY PROVIDE FOR DIFFERENT ALLOCATION.—

"(A) IN GENERAL.—*A State may, by law* enacted after the date of enactment of this subsection, *provide a different formula* for allocating the State ceiling among the governmental units in such State having authority to issue private activity bonds.

"(B) INTERIM AUTHORITY FOR GOVERNOR.—

"(i) IN GENERAL.—The Governor of any State may proclaim a different formula for allocating the State ceiling among the governmental units in such State having authority to issue private activity bonds.

"(ii) TERMINATION OF AUTHORITY.—*The authority provided in clause (i) shall not apply after the earlier of*—

"(I) the first day of the first calendar year beginning after the legislature has met in regular session for more than 60 days after the date of the enactment of this paragraph, *or*

"(II) the effective date of any State legislation with respect to the allocation of the State ceiling enacted after the date of the enactment of this subsection.

The regulations, however, read as follows (emphasis added):

The authority of the governor to proclaim a different formula shall not apply after the earlier of (i) the first day of the first calendar year beginning after the legislature of the State has met in regular session for more than 60 days after July 18, 1984, and (ii) the effective date of any State legislation dealing with the allocation of the State ceiling. *If, on or before either date, the governor of any State exercises the authority to provide a different allocation, such allocation shall be effective until the date specified in (ii) of the immediately preceding sentence.*

Regarding the length of time that the governor's allocation shall be effective, the statute was clear. However, the interpretation given to subparagraph (6)(B) on interim authority by the Treasury regulations contradicts the statutory language above in subparagraph (6)(A). (6)(A) reads that "a state may . . . by law . . . provide a different formula . . ." The regulations would allow a governor to establish a different formula, limiting only the period of time within which he or she must proclaim the allocation. Interim authority provided for the governor is an important provision for states because legislatures meet according to widely varying schedules. However, interpreting this authority to allow a governor's allocation to stand after a legislative session has failed to enact a statute interferes with the balance of state powers. It could lead to a requirement that while the governor can establish a formula by executive order, only a super majority of the legislature can provide a legislative role in the establishment of a different formula since by vetoing the legislature's proposed formula, the governor can protect his or her allocation formula. I ask that the Technical Corrections Act provide whatever language is necessary to change the Treasury Department's interpretation to reflect the intent of the Congress.

The constitutions of the states should be respected by federal law unless expressly preempted and then only for sound and demonstrated national need. Treasury's interpretation of this interim authority biases the balance of power between the executive and legislative branches. While I can sympathize with the federal agency's concern that the legislature and the governor may not find it easy to agree on what is likely to be a controversial subject, Treasury's approach can promote a stalemate situation resulting in the continuation of the governor's proclamation. The sunset

date (the earlier of (i) or (ii) above) for any gubernatorial interim allocation will promote discussion and negotiation aimed at developing state legislation.

For your information, I have attached a chart of the states showing the party of the Governor and the State Legislative Houses. As you might imagine, on an issue such as this, the difference of party affiliation might be a guide to differences on policy.

However, I remind you that this is basically an issue of respecting the procedures, laws and constitutions of the states. Your statutory language in my opinion did this, providing an incentive for timely joint action. Treasury's interpretation is in error and would jeopardize the joint effort in many states.

Also attached is is a chart showing the constitutional provisions for the length of the state legislative sessions. This can provide you with information on the best replacement for the current 60 days. A possible proposal would be to reinstate the original language beginning with the date of enactment of this new act, and make January 1, 1986 the optional sunset date in any state which meets for 60 or more regular session days in 1985 after the date of enactment, make January 1, 1987 the optional sunset date for states that meet in regular session for any number of days during 1986, and January 1, 1988 the sunset date for any state which won't have a regular session in 1986. These states would be Arkansas, Montana, Nevada, North Dakota, Oregon and Texas. While this may draw out the process for several more years, it is necessary because of the force of the Treasury regulations which have been in effect this year. Nevertheless, the principle will again be established of the need for joint legislative and executive action to enact a statutory allocation.

I thank you for this opportunity to address you. I'd be glad to answer any questions you may have.

	Party Control			Split	All
	Sen.	House	Gov.	Legis.-Gov.	Same Party
ALABAMA	D	D	D		X
ALASKA	R	D	D		
ARIZONA	R	R	D	X	
ARKANSAS	D	D	D		X
CALIFORNIA	D	D	R	X	
COLORADO	R	R	D	X	
CONNECTICUT	R	R	D	X	
DELAWARE	D	R	R		
FLORIDA	D	D	D		X
GEORGIA	D	D	D		X
HAWAII	D	D	D		X
IDAHO	R	R	D	X	
ILLINOIS	D	D	R	X	
INDIANA	R	R	R		X
IOWA	D	D	R	X	
KANSAS	R	R	D	X	
KENTUCKY	D	D	D		X
LOUISIANA	D	D	D		X
MAINE	D	D	D		X
MARYLAND	D	D	D		X
MASSACHUSETTS	D	D	D		X
MICHIGAN	R	D	D		
MINNESOTA	D	R	D		
MISSISSIPPI	D	D	D		X
MISSOURI	D	D	R	X	
MONTANA	D	tie	D		
NEBRASKA	non-partisan		D		
NEVADA	D	R	D		
NEW HAMPSHIRE	R	R	R		X
NEW JERSEY	D	D	R	X	
NEW MEXICO	tie	D	D		
NEW YORK	R	D	D		
NORTH CAROLINA	D	D	R		
NORTH DAKOTA	R	R	D	X	
OHIO	R	D	D		
OKLAHOMA	D	D	D		X
OREGON	D	D	R	X	
PENNSYLVANIA	R	D	R		
RHODE ISLAND	D	D	R	X	
SOUTH CAROLINA	D	D	D		X
SOUTH DAKOTA	R	R	R		X
TENNESSEE	D	D	R	X	
TEXAS	D	D	D		X
UTAH	R	R	R		X
VERMONT	D	R	D		
VIRGINIA	D	D	D		X
WASHINGTON	D	D	D		X
WEST VIRGINIA	D	D	R	X	
WISCONSIN	D	D	D		X
WYOMING	R	R	D	X	

Table 13
LEGISLATIVE SESSIONS: LEGAL PROVISIONS

State or other jurisdiction	Regular sessions: Legislature convenes: Year	Regular sessions: Legislature convenes: Month	Regular sessions: Legislature convenes: Day	Regular sessions: Limitation on length of session(a)	Special sessions: Legislature may call	Special sessions: Legislature may determine subject	Special sessions: Limitation on length of session
Alabama	Annual	Jan. Apr. Feb.	2nd Tues.(b) 3rd Tues.(c,d) 1st Tues.(e)	30 L. in 105 C	No	Yes(f)	12 L. in 30 C
Alaska	Annual	Jan. Jan.	3rd Mon.(c) 2nd Mon.(e)	None	By 2/3 vote of members	Yes(g)	30 C
Arizona	Annual	Jan.	2nd Mon.	(h)	By petition, 2/3 members, each house	Yes(g)	None
Arkansas	Biennial-odd year	Jan.	2nd Mon.	60 C(i)	No	(j)	(j)
California	(k)	Jan.	1st Mon.(d)	None	No	No	None
Colorado	Annual	Jan.	Wed. after 1st Tues.	(l)	By request, 2/3 members, each house	Yes(g)	None
Connecticut	Annual(m)	Jan. Feb.	Wed. after 1st Mon.(n) Wed. after 1st Mon.(n)	(p)	Yes(q)	(q)	None(r)
Delaware	Annual	Jan.	2nd Tues.	June 30	Joint call, presiding officers, both houses	Yes	None
Florida	Annual	Apr.	Tues. after 1st Mon.(d)	60 C(i)	Joint call, presiding officers, both houses	Yes	20 C(i)
Georgia	Annual	Jan.	2nd. Mon.(d)	40 L.	By petition, 3/5 members, each house	Yes(g)	(s)
Hawaii	Annual	Jan.	3rd Wed.	60 L(i)	By petition, 2/3 members, each house	Yes	30 L(i)
Idaho	Annual	Jan.	Mon. on or nearest 9th day	None	No	No	20 C
Illinois	Annual	Jan.	2nd Wed.	None	Joint call, presiding officers, both houses	Yes	None
Indiana	Annual	Jan.	2nd Mon.(d,t)	odd-61 L or Apr. 30; even-30 L or Mar. 15	No	Yes	30 L in 40 C
Iowa	Annual	Jan.	2nd. Mon.	(u)	By petition, 2/3 members, both houses	Yes	None
Kansas	Annual	Jan.	2nd Mon.	odd-None; even-90 C(i)	Petition to governor of 2/3 members, each house	Yes	None
Kentucky	Biennial-even yr.	Jan.	Tues. after 1st Mon.(d)	60 L.(v)	No	No	None
Louisiana	Annual	Apr.	3rd Mon.	60 L. in 85 C	By petition, majority, each house	Yes(g)	30 C
Maine	(k,m)	Dec. Jan.	1st Wed.(b) Wed. after 1st Tues.(o)	100 L. 50 L.	Joint call, presiding officers, with consent of majority of members of each political party, each house	Yes(g)	None
Maryland	Annual	Jan.	2nd Wed.	90 C(i)	By petition, majority, each house	Yes	30 C

Massachusetts	Annual	Jan.	1st Wed.	None	No		Yes	None
Michigan	Annual	Jan.	2nd Wed.(d)	120 L or 1st Mon. after	No		No	None
Minnesota (x)		Jan.	Tues. after 1st Mon. (n)	3rd Sat. in May(z)	No		No	60 C
				125 C(b,y); 90 C(b,y)	No			
Mississippi	Annual	Jan.	Tues. after 1st Mon.	odd-June 30; even-May 15			Yes	None
Missouri	Annual	Jan.	Wed. after 1st Mon.					
				90 L	By petition, majority, each house		Yes	None
Montana	Biennial-	Jan.	1st Mon.		By petition, 2/3 members, each house		No	20 C(u)
	odd yr.			odd-90 L(i); even-60 L(i)	By petition			
	Annual	Jan.	Wed. after 1st Mon.	60 C(u)	No		Yes	(u)
Nebraska	Biennial-	Jan.	3rd Mon.					
	odd yr.			90 L or July 1(u)	By 2/3 vote of members		Yes	None
Nevada	Biennial-	Jan.	Wed. after 1st Tues.(d)					
	odd yr.				By petition, majority, each house		Yes(g)	30 C
New Hampshire	Annual	Jan.	2nd Tues.	None	By petition, 3/5 members, each house		Yes(g)	None
				odd-60 C; even-30 C	By petition, 2/3 members, each house		Yes	None
New Jersey	Annual(m)	Jan.	3rd Tues.	None	By petition, 3/5 members, each house		Yes	None
	Annual	Jan.	Wed. after 1st Mon.	None(x)	No			
New Mexico	(z)	Jan.	Wed. after 2nd Mon.(n)	80 L(r)			Yes	None
New York	Biennial-	Jan.	Tues. after Jan. 3, but not		Joint call, presiding officers, both houses			
North Carolina	odd yr.		later than Jan. 11(d)	None			Yes	None
North Dakota	Annual	Jan.	1st Mon.		By 2/3 vote of members		Yes	None
				90 L	By petition, majority, each house			
Ohio	Annual	Jan.	Tues. after 1st Mon.	None			No	None
	Biennial-	Jan.	2nd Mon.		By petition, majority, each house		No	None
Oklahoma	odd yr.			None	No		Yes	None
Oregon	Annual	Jan.	1st Tues.	60 L (u)	No			
	Annual	Jan.	1st Tues.	1st Thurs. in June(i)			No	None
Pennsylvania	Annual	Jan.	2nd Tues.(d)				Yes	30 L(u)
Rhode Island				odd-40 L; even-35 L	No		No	30 C
South Carolina	Annual	Jan.	Tues. after 1st Mon.	90 L (u)	By petition, 2/3 members, each house			
	(z)	Jan.	(aa)	140 C	No		No	30 C
South Dakota	Biennial-	Jan.	2nd Tues.				Yes	None
Tennessee	odd yr.			odd-60 C; even-20 C	No			
Texas	Annual(m)	Jan.	2nd Mon.	(u)	No		Yes	None
	(z)	Jan.	Wed. after 1st Mon.(n)				Yes	30 C
Utah				odd-30 C(i); even-60 C(i)	By petition, 2/3 members, each house		Yes(bb)	None
Vermont		Jan.	2nd Wed.	odd-105 C; even-60 C	By petition, 2/3 members, each house			
	Annual	Jan.	2nd Mon.	60 C(i)	By petition, 3/5 members, each house		No	None
Virginia	Annual	Jan.	2nd Wed.(c,e)					
Washington	Annual	Feb.	2nd Wed.(e)		No			
West Virginia	Annual	Jan.	1st Tues. after Jan. 1(d,n)	None				
Wisconsin	Annual(cc)	Jan.						

LEGISLATIVE SESSIONS: LEGAL PROVISIONS—Continued

State or other jurisdiction	Regular sessions: Legislature convenes: Year	Regular sessions: Legislature convenes: Month	Regular sessions: Legislature convenes: Day	Regular sessions: Limitation on length of session(a)	Regular sessions: Legislature may call	Special sessions: Legislature may determine subject	Special sessions: Limitation on length of session
Wyoming	Annual(m)	Jan. Feb.	2nd Tues.(n) 2nd Tues.(o)	odd-40 L.; even-20 L.	No	Yes	None
Dist. of Col.	(dd)	Jan.	2nd day	None	No	No	None
American Samoa	Annual	Jan. July	2nd Mon. 2nd Mon.	45 L. 45 L.	No	No	None
Guam	Annual	Jan.	1st Mon.(ee)	None	No	No	20 C
Puerto Rico	Annual	Jan.	2nd Mon.	Apr. 30(i)	No	No	15 C
Virgin Islands	Annual	Jan.	2nd Mon.	75 L.	No	No	15 C

Note: Some legislatures will also reconvene after normal session to consider bills vetoed by governor. Connecticut—if governor vetoes any bill, secretary of state must reconvene General Assembly on second Monday after the last day on which governor is either authorized to veto bill or has transmitted every bill with his objections, whichever occurs first; General Assembly must adjourn *sine die* not later than three days after its reconvening. Hawaii—legislature may reconvene on 45th day after adjournment *sine die*, in special session, without call. Louisiana—legislature meets in a maximum five-day veto session on the 40th day after final adjournment. Missouri—if governor returns any bill on or after the fifth day before the last day on which legislature may consider bills (in even-numbered years), legislature automatically reconvenes on first Monday in September for a maximum 10 C session. New Jersey—legislature meets in special session (without call or petition) to act on bills returned by governor on 45th day after *sine die* adjournment of the first year of a two-year legislature; a special session may not be convened if the 45th days falls on or after the last day of the legislative year in which the second session occurs. Virginia—legislature reconvenes on sixth Wednesday after adjournment for a maximum three-day session (may be extended to seven days upon vote of majority of members elected to each house). Utah—if 2/3 of the members of each house favor reconvening to consider vetoed bills, a maximum five-day session is set by the presiding officers. Washington—upon petition of 2/3 of the members of each house, legislature meets 45 days after adjournment for a maximum five-day session.

Key:

C—Calendar day

L—Legislative day (in some states, called a session day or workday; definition may vary slightly, however, generally refers to any day on which either house of the legislature is in session)

(a) Applies to each year unless otherwise indicated.

(b) General election year (quadrennial election).

(c) Year after quadrennial election.

(d) Meets in organizational session prior to stated convening date. Alabama—in the year after quadrennial election, on the second Tuesday in January for 10 C. California—in the even-numbered, general election year, on first Monday in December for an organizational session, recess until the first Monday in January of the odd-numbered year. Florida—in general election year, 14th day after election. Georgia—in odd-numbered year. Indiana—third Tuesday after first Monday in November. Kentucky—in odd-numbered year, Tuesday after first Monday in January for 10 L. Michigan—held in odd numbered year. New Hampshire—in even-numbered year, first Wednesday in December. North Dakota—in even-numbered year, Tuesday after first Monday in December of three day session. South Carolina—in even-numbered year, Tuesday after certification of election of its members for a maximum three-day session. West Virginia—in year after general election, on second Wednesday in January.

(e) Other years.

(f) By 2/3 vote each house.

(g) Only if legislature convenes itself. Special sessions called by the legislature are unlimited in scope in Arizona, Georgia, Maine and New Mexico.

(h) No constitutional or statutory provision; however, legislative rules require that regular sessions adjourn no later than Saturday of the week during which the 100th day of the session falls.

(i) Session may be extended by vote of members in both houses. Arkansas: 2/3 vote. Florida: 3/5 vote. Hawaii: petition of 2/3 membership for maximum 15-day extension. Kansas: 2/3 vote. Maryland: 3/5 vote for maximum 30 C. Mississippi: 2/3 vote for 30-day extension, no limit on number of extensions. Nebraska: 4/5 vote. South Carolina: 2/3 vote. Virginia: 2/3 vote for 30-day extension. West Virginia: 2/3 vote (or if budget bill has not been acted upon three days before session ends, governor issues proclamation extending session). Puerto Rico: joint resolution.

(j) After governor's business has been disposed of, members may remain in session up to 15 C by a 2/3 vote of both houses.

(k) Regular sessions begin after general election, in December of even-numbered year. In California, legislature meets in December for an organizational session, recesses until the first Monday in January of the odd-numbered year and continues in session until Nov. 30 of next even-numbered year. In Maine, session which begins in December of general election year runs into the following year (odd-numbered); second session begins in next even-numbered year.

(l) A 1982 constitutional amendment imposed a time limit of 140 C on regular sessions convening in even-numbered years.

(m) Second session limited to consideration of specific types of legislation. Connecticut—individual legislators may only introduce bills of a fiscal nature. Maine—budgetary matters; legislation in the governor's call; emergency legislation; legislation referred to committees for study. New Mexico—budgets, appropriations and revenue bills; bills drawn pursuant to governor's message; vetoed bills. Utah, Wyoming—budget bills (however, in Utah, by vote of 2/3 members, may consider non-budgetary bills).

(n) Odd-numbered years.

(o) Even numbered years.

(p) Odd-numbered years—not later than Wednesday after first Monday in June; even-numbered years—not later than Wednesday after first Monday in May.

(q) Constitution provides for regular session convening dates and allows that sessions may also be held "... at such other times as the General Assembly shall judge necessary." Call by majority of legislators is implied.

(r) Upon completion of business.

(s) Limited to 30 days if called by governor and 30 days if called by petition of the legislature, except in cases of impeachment proceedings.

(t) Legislators may reconvene at any time after organizational meeting; however, second Monday in January is the final date by which regular session must be in process.

(u) Indirect limitation. Restrictions on legislators' pay, per diem or daily allowance.

(v) May not extend beyond April 15.

(w) Joint rules provide for the submission of a written statement requesting special session by a specified number of members of each chamber.

(x) Legal provision for session in odd-numbered year; however, legislature may divide, and in practice has divided, to meet in even-numbered years as well.

(y) A 1968 constitutional amendment calls for 90 C sessions every year, except the first year of a gubernatorial administration during which the legislative session runs for 125 C.

(z) No legislative day is shorter than a natural day.

(aa) Commencement of regular session depends on concluding date of organizational session. Legislature meets, in odd-numbered year, on second Tuesday in January for a maximum 15 C organizational session, then returns on the Tuesday following the conclusion of the organizational session.

(bb) According to a 1955 attorney general's opinion, when the legislature has petitioned to the governor to be called into session, it may then act on any matter.

(cc) The legislature, by joint resolution, establishes the session schedule of activity for the remainder of the biennium at the beginning of the odd-numbered year.

(dd) Each Council period begins on January 2 of each odd-numbered year and ends on January 1 of the following odd-numbered year.

(ee) Legislature meets on the first Monday of each month following its initial session in January.

STATEMENT OF THE NATIONAL COORDINATING COMMITTEE FOR MULTIEMPLOYER PLANS

OUTLINE

A. The Technical Corrections Act of 1985 (H.R. 1800) ("Bill").

1. Permissible welfare plan reserves.

a. The limits for tax deductible contributions and tax exempt reserves for collectively bargained welfare funds should be set forth explicitly in Code [1] section 419A.

b. Additional welfare plan reserve limit issues.

i. The welfare benefit plan reserve limit transition rules of Code section 419A(f)(7) should be made available to all plans that had reserves as of the beginning and end of the plan year that includes the date the DRA was enacted. Further, it should apply to collectively bargained plans that had reserves as of the end of such plan year and either: (1) did not increase contribution rates between enactment of the DRA and the end of such plan year; or (2) did increase such rates, but did not at that time plan to decrease them after the end of such plan year. The transition rules of Code section 512(a)(3)(E) should apply to reserves as of the end of such plan year.

ii. The Bill should make clear that the exemption of an insurance policy from the definition of "fund" applies even if an experience-rated refund or insurance policy dividend is payable to a collectively bargained trust, and is not taxable to the trust.

2. Other multiemployer plan issues.

a. The collective bargaining exceptions to the nondiscrimination requirements of Code sections 419A(e)(1) and 4976(b)(1) should apply in all cases where welfare benefits in the aggregate are bargained to be provided in accordance with section 302(c)(5) of the Taft-Hartley Act.

b. The current collectively bargained plan effective date for the rules added by the DRA to the Unrelated Business Taxable Income ("UBTI") provisions of Code section 512, and the excise tax provisions of Code section 4976 should not be changed.

c. Multiemployer plans should not be required to be aggregated with other plans of contributing employers for any purposes of Code section 419A. Workable rules should be promulgated whereby contributing employers can permissively aggregate their single employer plans with their allocable portions of the multiemployer plans to which they contribute.

d. The Bill or its legislative history should clarify whether the proposed repeal of Code section 2517 (which exempts from gift tax an employee's designation of a beneficiary under a qualified plan) would subject a contingent or revocable designation of a plan beneficiary to tax. It should also clarify whether a spouse that consents to waive his or her right to a death benefit would be subject to gift tax liability, and how any gift or estate tax of qualified plan death benefits is coordinated with the income tax treatment of plan payments to the beneficiary.

e. Multiemployer plans should be exempted from the top-heavy plan provisions of Code sections 416 and 401(a)(10)(B). Workable rules should be provided whereby employers, in testing their single employer plans for top-heaviness, can receive credit for their "share" of benefits under a multiemployer plan to which they contribute. Such credit should be available regardless of whether benefits under the plans are "comparable."

f. Code section 419(e)(2), which defines "welfare benefits" should explicitly include in such definition a post-retirement cost of living adjustment benefit, which, pursuant to ERISA section 3(2)(B), is treated as a welfare benefit under Department of Labor regulations.

B. H.R. 2110 ("Bill"), Making Technical Corrections to the Retirement Equity Act of 1984 ("REA").

1. A spouse that waives his or her right to death benefits should not be given a power of approval of his or her successor beneficiary. Certain technical problems also exist with respect to the Bill's proposal to require such approval.

2. The amendments proposed to section 303(c) of REA to avoid requiring that plans pay duplicate death benefits as a result of REA's pre-retirement spousal death benefit rules should allow plans to pay both a pre-existing death benefit and the REA benefit if their sponsors wish to do so. Further, the time period for the proposed opportunity for a spouse to waive his or her benefit should be extended to make such waiver feasible. Tax consequences of such a waiver should also be clarified.

3. Qualified domestic relations orders ("QDROs").

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[1] Internal Revenue Code of 1954, as amended.

a. Under REA, an ex-spouse is entitled to receive benefits under a QDRO even if the employee is still working. The rule that protects the tax-qualified status of a pension plan that honors such an award should not be changed. Providing payment pursuant to a QDRO should not disqualify a plan even if the benefits it must pay to the ex-spouse have a present value of more than $3,500. Certain technical problems also exist with respect to such proposal.

b. REA should be clarified to state that a plan should not be required to comply with or otherwise modify any actions addressed by a QDRO that take place before the QDRO is delivered to the plan.

4. The requirement of spousal consent to use of a participant's accrued benefit as security for a loan should be made effective January 1, 1986.

COMMENTS

The National Coordinating Committee for Multiemployer Plans ("NCCMP") is pleased to offer its comments on H.R. 1800, the Technical Corrections Act of 1985, and H.R. 2100, making technical corrections to the Retirement Equity Act of 1984.

The NCCMP is a nonprofit, tax-exempt organization established after Congress enacted ERISA in 1974. It consists of representatives of more than 140 pension and welfare plans, or their sponsors, through which, in the aggregate, the interests of approximately three million persons are represented. On behalf of its affiliated multiemployer plans and their participants and beneficiaries, the NCCMP is entirely engaged in monitoring the development—legislative, administrative, and judicial—of the laws relating to the structuring and administration of multiemployer pension and welfare plans.

We suggest reconsideration of several aspects of the technical corrections bills as they would apply to multiemployer plans. We also note the possibility of technical improvements in certain provisions.

A. The Technical Corrections Act of 1985 ("Bill")

1. Permissible Welfare Plan Reserves

A. RESERVE LIMITS APPLICABLE TO COLLECTIVELY BARGAINED WELFARE PLANS

Section 419A [2] as added by the Deficit Reduction Act of 1984 ("DRA"), provides tax deductible reserve limits for welfare plans. Section 419A(f)(5) directs the Secretary of Treasury to provide special, higher limits for collectively bargained plans no later than July 1, 1985.

The Conference Report states:

> "Certain collectively bargained plans.—By July 1, 1985, the Treasury Department is to publish final regulations establishing special reserve limit principles with respect to welfare benefit funds maintained pursuant to an agreement that the Secretary of Labor finds to be a collective bargaining agreement between employee representatives and one or more employers, if there is evidence of good faith bargaining over the benefits provided by the plan between the employee representatives and the employer (or employers).
>
> "In establishing these limits, the Treasury is to presume that reserves in such plans are not excessive because of the arm's length negotiations between adversary parties inherent in the collective bargaining process. Because contributions under such plans are often made on the basis of a defined contribution fixed over a multiyear period on the basis of economic assumptions which prove to be incorrect and because such contributions may be the only source of benefits to be provided during layoffs, strikes, lockouts, and economic recession, these special limits are to allow substantial flexibility in determining the application of these provisions with respect to such plans." H.R. Rep. No. 861, 98th Cong., 2d Sess. 1158 (1984).

In this report, Congress clearly stated two things about collectively bargained plans. First, the nature of such plans, and of the collective bargaining process, generally precludes the abuses of principal concern. Second, the practical requirements of such plans (*e.g.*, the need to set contributions at some fixed rate based on hours of work or units of production) and the plans' basic economics,[3] mandate special reserve principles.

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[2] Unless otherwise stated, all references herein are to the Internal Revenue Code of 1954, as amended.

[3] Employer contributions do not rise to meet plan needs. Instead, they generally fall in times of aggravated participant need, *e.g.*, recession, strike or layoff.

Recognizing the basic facts set forth above, Congress also gave specific instruction as to how the situation should be handled: the reserves of such plans are to be presumed reasonable. In other words, the reserve limitations of this newly-enacted provision are not generally to apply in the case of collectively bargained plans.

Perhaps it is possible for the Treasury to fashion regulations accurately reflecting the Congressional intent discussed above. However, after a review of many specific situations, and a good bit of effort, we have been unable to devise any formula or other standardized approach that would cover the vast array of fact patterns actually presented.

Perhaps the regulations could merely restate the generalized intent reflected in the report, providing that the reserves of collectively bargained plans will be deemed within the appicable reserve limitations, unless the IRS establishes their unreasonableness in particular situations. Such a regulation would be entirely appropriate if the problem is actually to be addressed by regulation. However, the Congressionally imposed deadline is upon us, and guidance is desperately needed now.

Given the foregoing, we submit that Congressional intent would best be served by explicit statutory language setting forth a general rule on the reasonableness of reserves in collectively bargained plans. Such an approach makes particularly good sense in light of the nearness of the July 1, 1985 deadline set by Congress for final regulations on this subject. Proposed regulations have not yet been issued, and timely issuance of carefully developed regulations seems unlikely given the current agenda of appropriate Treasury and IRS personnel.

Consequently, we suggest that Code section 419A(f)(5) be amended in its entirety to read as follows:

"(5) HIGHER LIMIT IN CASE OF COLLECTIVELY BARGAINED PLANS.—

"(A) Notwithstanding any other provisions of this section, for purposes of sections 419 and 512, the limit determined under this section for a qualified asset account established by a welfare benefit fund maintained pursuant to one or more agreements that the Secretary of Labor finds to be collective bargaining agreements between employee representatives and one or more employers shall be no less than the amount credited to that account, if—

"(i) there is evidence of good faith bargaining over funding for the benefits provided through the fund and

"(ii) the Secretary does not find that the fund's reserves are unreasonable, taking into account past experience and reasonable expectations. For this purpose, an amount in a reserve attributable to employer contributions shall be deemed to be reasonable if the level of contributions required was reasonably expected to be necessary to maintain the plan of which the fund is a part, under all of the circumstances existing and anticipated at the time the collective bargaining agreement setting the contribution obligation was agreed to.

"(B) For purposes of this paragraph, the term "amount credited to that account" includes assets to provide for the future payment of any welfare benefit, within the meaning of section 419(e)(2), in addition to the benefits listed in subsection (a) of this section."

The problems described above are particularly acute with respect to multiemployer plans. Such plans are required by the Taft-Hartley Act to function as jointly administered trusts. In these circumstances benefits cannot be provided directly from the general assets of employers. "Welfare benefit funds" must be utilized if benefits are to be provided at all.

Further, once an employer makes a contribution to a multiemployer plan, the money is gone forever. Also individual employers, as such, typically have little or no direct role in the plan trustees' decisions about what benefits to provide. Thus, unlike the situation that may exist in some single-employer plans, there is neither opportunity nor motive for "packing" with excess funds in order to accelerate deductions.

B. ADDITIONAL WELFARE PLAN RESERVE LIMIT ISSUES

Additional reserve limit issues are addressed below. We note, however, that these issues will become moot if the amendment suggested above becomes law.

i. Reserve limit transition rules

Section 151(a)(7) of the Bill would make the reserve limit transition rules of section 419A(f)(7) available only to funds that had reserves "as of July 18, 1984." This is clearly meant to deny transition relief to employers who, for tax purposes, made

large welfare plan contributions between enactment of the DRA and the end of 1984.

However, the new rule, as presently structured, would create unnecessary administrative burdens. Plans do not keep daily records of the status of their reserves. Thus, most plan trustees will not know if the plan had reserves as of July 18, 1984. They would be able to determine this, if at all, only through retroactive reconstruction of the plan's financial status as of that date.

We suggest that the transition rules be made available, instead, to plans that had reserves as of both the beginning and the end of the plan year that includes July 18, 1984. This would adequately test plans on the basis of information they ordinarily have available.

In addition, for collectively bargained plans, the transition rules should apply if:

"(A) The plan had reserves as of the end of the plan year that includes July 18, 1984, and

"(B) Either:

"(i) no increase in the rate of contributions under the collective-bargaining agreement was negotiated between July 18, 1984, and the end of the plan year that included July 18, 1984; or

"(ii) If a post-July 18, 1984, contribution rate increase was negotiated, such increase did not provide for a decrease after the end of the plan year that included July 18, 1984."

This would make the transition rules unavailable to plans that increased contributions until the end of 1984 to inflate the 1984 reserve for tax purposes. However, the rules would remain available in bona fide situations where deficits existed at the beginning of the 1984 plan year but, because of benefit cuts or legitimate contribution rate increases, there were surpluses by the end of that year.

A similar problem arises under section 151(a)(10)(C)(iii) of the Bill. That section would amend Code section 512(a)(3)(E)(iii)(II) to impose income tax on the earnings of the post-retirement medical or life insurance welfare fund reserves in excess of the amount the fund had accumulated for such purposes as of July 18, 1984. As stated, it would be difficult, if not impossible, for plans to determine the reserves that existed on such a specific date. Instead, the test should be the existing level of reserves for such purposes as of the end of the plan year that includes July 18, 1984. Safeguards similar to those suggested above with respect to section 419A could be provided to prevent abuse.

ii. Treatment of certain insurance contracts

Section 151(a)(8) of the Bill would exclude certain types of insurance contracts from the definition of a "welfare benefit fund." The exclusion would apply only if "the amount of any experience-rated refund or policy dividend payable to an employer with respect to a policy year is treated by the employer as received or accrued in the taxable year in which the policy year ends." This limitation is clearly intended to apply the credit income to reduce the employer's deduction for the initial premium. However, this rationale does not apply in the context of tax-exempt trusts. Accordingly, the legislative history should state that this limitation applies only if the experience credit is paid directly to an employer, and is not relevant if the contract holder that receives the credit is a tax-exempt trust.

2. Other Multiemployer Plan Issues

There are a number of other issues which are of importance to multiemployer plans, regardless of the disposition of the collectively bargained reserve limit issue.

A. COLLECTIVE BARGAINING EXCEPTIONS TO NONDISCRIMINATION REQUIREMENTS OF SECTIONS 419A(E)(1) AND 4976(b)(1)

Section 419A(e)(1) currently provides that no reserve may be taken into account under section 419A(c)(2) for post-retirement medical benefits or life insurance benefits unless the plan meets the nondiscrimination requirements of section 505(b)(1). Section 4976 imposes an excise tax on employers maintaining funds that provide "disqualified benefits." Under section 4976(b)(1), "disqualified benefits" include post-retirement medical or life insurance benefits, unless the plan meets the nondiscrimination requirements of section 505(b)(1) with respect to such benefits.

Sections 151(a)(3) and 151(a)(11) of the Bill would apply these rules to plans, such as collectively bargained plans, that are not otherwise subject to section 505. There would be an exception for benefits provided by a plan maintained under a collective bargaining agreement, if the post-retirement medical and life insurance benefits were the subject of good-faith bargaining.

Post-retirement welfare benefits, as such, are not necessarily the subject of direct bargaining in the multiemployer context. The bargaining parties often denominate separate contributions for pension and for welfare benefits. They ordinarily do not specify the actual benefits to be provided or the portion of the welfare benefit contributions that will be used to provide any particular type of benefit. Instead, these decisions are left to the plan trustees.

Since the intent of the change seems to be to continue the current law standard exception for collectively bargained plans, an additional exemption should be added with respect to both sections 419A(e)(1), and 4976(b)(1) for "benefits provided in the manner described in paragraphs (5) et seq. of 29 U.S.C. section 186(c)"—i.e., collectively bargained and provided through a jointly managed trust in accordance with Taft-Hartley.

B. EFFECTIVE DATE OF SECTION 512 UNRELATED BUSINESS TAXABLE INCOME ("UBTI") AND SECTION 4976 EXCISE TAX CHANGES

Under section 511(e)(2) of the Deficit Reduction Act of 1984 ("DRA"), the new UBTI provisions of section 512, and excise tax provisions of section 4976 will not apply to collectively bargained plans until the first day of the plan year starting after expiration of the longest-running labor contract in effect on July 1, 1985. Section 151(a)(12) of the Bill would add new paragraphs (6) and (7) to the end of section 511(e) as follows:

> "(6) AMENDMENTS RELATED TO TAX ON UNRELATED BUSINESS INCOME.—The amendments made by subsection (b) [UBTI provisions] shall apply with respect to taxable years ending after December 31, 1985. . . .
>
> "(7) AMENDMENTS RELATED TO EXCISE TAXES ON CERTAIN WELFARE BENEFIT PLANS.—The amendments made by subsection (c) [excise taxes on disqualified benefits] shall apply to benefits provided after December 31, 1985."

The Bill should make clear that these new paragraphs are not intended to override the collective bargaining effective date provided in paragraph (2) of section 511(e) of the DRA. It would be difficult, if not impossible, for collectively bargained plans to comply with a January 1, 1986 effective date. Treasury will not announce the special reserve limits applicable to such plans until July 1, 1985, at the earliest. Further, there is no practical opportunity to readjust contribution rates until the expiration of the currently effective collective bargaining agreement. Finally, until passage of the Technical Corrections Bill, the extent, if any, to which a plan's benefit structure will have to be amended will remain uncertain. See section 1., supra.

C. AGGREGATION OF PLANS

Section 419A provides limits on the amount of disability and SUB or severance pay benefits and life insurance benefits that can be taken into account in determining permissible plan reserves. Further, it treats amounts allocable to individual accounts of key employees to pay post-retirement medical benefits as annual additions under section 415(c).

Section 151(a)(6) of the Bill would provide that, for purposes of these provisions, all welfare benefits of an employer must be treated as a single fund. For all other purposes of Section 419A, an employer would be permitted to elect to treat two or more welfare benefit funds he maintains as one fund.

Multiemployer welfare plans have no way of knowing whether contributing employers have other welfare plans. They have no control over or knowledge of contributions to or benefits under other plans of contributing employers. Thus, requiring multiemployer plans to aggregate single employer benefits for this purpose would be unfair and unworkable.

Further, higher reserve limits are to be prescribed for collectively bargained plans, including multiemployer plans. Thus, the limits on the amount of disability and SUB or severance pay benefits and life insurance benefits should not apply to such plans. With respect to the section 415(c) limits, if benefits under an aggregation of plans exceed such limits, Treasury regulations provide that benefits under the single employer, rather than the multiemployer, plan will be reduced. See Treas. Reg. §§ 1.415–8(e), 1.415–9(a)(3).

Accordingly, no purpose would be reserved by subjecting multiemployer plans to the required aggregation rules. Such plans should therefore be exempted.[4]

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[4] We note that aggregation of plans is also required for purposes of the UBTI rules added by the DRA. § 512(a)(3)(E)(iii)(III). Our comments apply equally in this context. However, the Secretary of Treasury is empowered to provide exceptions by regulations. We hope and expect that such regulations will provide the necessary exemption.

The Bill could nevertheless require a single employer plan to be aggregated with a multiemployer plan to the extent of that portion of the multiemployer plan that is allocable to the employer's employees. If the aggregated plans exceed the limits, however, only the single employer plan should be affected. For this purpose, the Treasury should be directed to promulgate simple, workable rules for allocating a share of the multiemployer plan's assets and liabilities to each contributing employer, without the burden and expense of tracing their actual source.

D. GIFT TAX CHANGES

Section 152(e) of the Bill would repeal section 2517, which creates a gift tax exemption for an employee's designation of a beneficiary under a qualified pension or profit-sharing plan. The statute or legislative history should clarify whether a contingent or revocable designation of a plan beneficiary would be subject to tax. It should also clarify whether a spouse that consents, in accordance with the Retirement Equity Act of 1984, to waive his or her right to a death benefit would be subject to gift tax liability. Income tax treatment of amounts already considered part of a taxable gift or estate should also be clarified.

E. TOP-HEAVY PLAN PROVISIONS

Section 240 of the Tax Equity and Fiscal Responsibility Act of 1982 added a new section 416 which sets forth special rules for top-heavy plans. In general, a plan is considered top-heavy if the present value of the cumulative accrued benefits or aggregate account balances for certain highly paid officers and owners ("key employees") of the employer exceeds sixty percent of the present value of the cumulative accrued benefits or aggregate account balances of all employees under the plan. Code § 416(g). We note that section 152(d) of the technical corrections bill would make certain changes in the top-heavy provisions of the law.

The facts are that a multiemployer plan cannot be top-heavy, and that the sanctions applicable to top-heavy plans have no practical relevance in the multiemployer plan context.

The vast majority of multiemployer plan participants are bargaining unit employees who are generally not officers or owners of an employer and therefore not key employees. Further, most multiemployer plans provide non-integrated flat-dollar benefits that are unrelated to compensation. Thus, larger dollar benefit amounts are ordinarily based on longer terms of covered service rather than the higher pay that typically accompanies company ownership or officer status. The few key employees that might be covered by multiemployer plans would therefore have no advantage over non-key employees with respect to benefit accrual. It would therefore be virtually impossible for multiemployer plans to satisfy the definitional top-heaviness test of providing in excess of sixty percent of its benefits to key employees. For this reason, it would be unreasonable to subject multiemployer plans to the administrative compliance burdens of the top-heavy provisions.

Collectively bargained plans, including multiemployer plans, are already expressly exempted from the major substantive top-heavy requirements, *i.e.*, the section 416(b), (c), and (d) requirements relating to faster vesting, minimum benefits or contributions, and a ceiling on the amount of compensation that may be used to compute benefits. Code § 416(i)(4). However, multiemployer plans are not expressly exempted from the section 416(h)(1) reduction in the section 415(e) dollar limitation on combined contributions to and benefits under defined contribution and defined benefit plans maintained by the same employer.

Such plans are further burdened by the section 401(a)(10)(B) requirement that all plans adopt boilerplate language to take effect if they become top-heavy. Under Treasury regulations, a plan is relieved of this requirement if it covers only employees included in a bargaining-unit and employees of employee representatives. This relief is inadequate and impractical, however, because a multiemployer plan may cover a small number of other employees. For example, union members who have become self-employed may, in some plans, maintain continuity of coverage. A few plans allow "special class" participation through which a company's salaried employees are covered as long as its union-represented employees participate. Further, the Treasury regulations do not make clear whether the exception would apply to plans that cover employees of the plan itself.

It would be unreasonable to subject multiemployer plans to these burdensome provisions, since no meaningful protection to multiemployer plan participants would be provided and no perceived abuses corrected. We therefore seek a technical correction, which would make clear that multiemployer plans are exempted from the top-heavy requirements, including the burdensome requirement to adopt boilerplate,

top-heavy provisions that will almost certainly never become effective. The Secretary could be empowered to promulgate regulations limiting this exemption if necessary to prevent abuses.

The technical correction should also make clear that, for purposes of determining the top-heavy status of an employer's single employer plans, employers are to aggregate their share of the accrued liabilities of any multiemployer plan to which they contribute as though it were a separate plan. If this aggregation group is top-heavy, only the single employer, and not the multiemployer, plan would be considered top-heavy.

Employers should also be permitted to aggregate their single employer plans with their allocable share of a multiemployer plan's benefits, in testing for top-heaviness in their single employer plans. Such aggregation should be available regardless of whether benefits under the multiemployer plan are "comparable" to benefits under the single employer plans. The Secretary of Treasury should be directed to prescribe a simple, workable formula for determining each employer's "share" of multiemployer plan benefits for this purpose, without actually tracing contributions and benefits.

F. DEFINITION OF "WELFARE BENEFIT"

Section 419(e)(2) should be amended to make clear that the term "welfare benefit" includes a post-retirement cost-of-living adjustment benefit which, pursuant to ERISA section 3(2)(B), is treated as a welfare benefit under Department of Labor regulations. This would explicitly subject such benefits to the amendments made by the DRA in sections 419, 419A, and 512.

B. H.R. 2110 ("BILL") MAKING TECHNICAL CORRECTIONS TO THE RETIREMENT EQUITY ACT OF 1984 ("REA")

1. Spousal Consent to Beneficiary Designation

REA requires written spousal consent to a waiver of the spouse's right to death benefits. It does not require the spouse to formally consent to the employee's election of an alternative payment form, or choice of another beneficiary. Once the spouse relinquishes his or her right to a death benefit, the employee is free to do whatever he or she wants with it.

Section 2(b)(6) of the Bill would amend section 417(a)(2) to give the spouse greater power to determine the disposition of such benefits. The waiver would be effective only if:

> "(A)(i) The spouse of the participant consents in writing to such election, (ii) such election designates a beneficiary which may not be changed without spousal consent (or the consent of the spouse permits designations of beneficiaries by the participant without any requirement of further consent by the spouse), and (iii) the spouse's consent acknowledges the effect of such election and is witnessed by a plan representative or a notary public, . . ."

The change would apply to benefit elections made after the Bill's date of enactment.

In our view, the prevention of the occasional abuses at which this change is apparently aimed would not justify the administrative burdens that would be imposed on plans. Plans would be required to adopt yet another round of plan amendments. They would have to reprint appropriate forms, revise summary plan descriptions, mail additional explanations to employees etc. (At a minimum, these facts require a delayed effective date in the proposed change.)

There may be times when an employee designates a beneficiary his or her spouse did not contemplate and would not have approved. However, where the spouse has voluntarily waived his or her right to such benefit, the spouse's financial security will ordinarily not be enhanced through an ability to control the designation of the alternative beneficiary, if the employee can still choose a payout form that cuts out the spouse, e.g., lump sum, etc.

There are also technical problems with the proposed change. It would apparently require a spouse's waiver of his or her death benefit to be accompanied by the designation of another beneficiary. In most cases, however, a waiver of a qualified joint and survivor annuity at retirement will result in higher monthly annuity payments during the employee's lifetime, with no death benefit payable after the employee's death. And pre-retirement death benefits may be waived entirely, to avoid the charge for it that some plans are imposing. At a minimum, the Bill should accommodate these practices.

Further, qualified plans often provide death benefits in addition to, rather than instead of, the qualified spousal benefit. For example, multiemployer defined contribution plans are required to guarantee a spouse a pre-retirement death benefit based on only half of the employee's account. It would be useful for the legislative history to make clear that any waiver requirements apply only to the qualified joint and survivor and preretirement survivor benefits.

Involving the spouse in the beneficiary designation process could also create gift-tax problems for the spouse, if the proposal, in the Technical Corrections Act of 1985, to repeal Section 2517 is passed. If these provisions of the two technical corrections bills are enacted, the gift tax treatment of the spouse should be clarified.

2. Duplicate Death Benefits

Section 2(f) of the Bill would amend the joint and survivor transition rules in section 303(c) of REA to protect plans from having to pay duplicate death benefits as a result of the immediate effective date of REA's pre-retirement spousal death benefit rules, as follows:

> "(4) ELIMINATION OF DOUBLE DEATH BENEFITS.—(A) IN GENERAL.—In the case of a participant described in paragraph (2), the amount of any death benefit (other than a qualified preretirement survivor annuity) payable to any beneficiary shall be reduced by the amount payable to the surviving spouse of such participant by reason of paragraph (2).
>
> "(B) SPOUSE MAY WAIVE PROVISIONS OF PARAGRAPH (2).—In the case of any participant described in paragraph (2), the surviving spouse of such participant may waive the provisions of paragraph (2). Such waiver shall be made on or before the close of the first plan year to which the amendments made by this Act apply. Such a waiver shall not be treated as a transfer of property for purposes of chapter 12 of the Internal Revenue Code of 1954 and shall not be treated as an assignment or alienation for purposes of section 401(a)(13) of the Internal Revenue Code of 1954 or section 206(d) of the Employee Retirement Income Security Act of 1974."

A few technical modifications are required with respect to this proposed change. It would apparently require an offset of the spousal benefit in all cases. However, plans often pay both a pre-existing death benefit and the REA benefit (e.g., in a money purchase plan where the REA benefit is only half of the account, or in cases where there is a separate children's benefit). Further, where the spouse is already the designated beneficiary for the pre-existing death benefit, the plan may offer him or her the choice between that and the REA benefit.

Accordingly, we suggest that the word "shall" in the proposed amendment be changed to "may." This would avoid requiring plans to reduce or eliminate benefits they intend to provide in addition to the REA benefit.

In addition, the proposed change would give a spouse the right to waive his or her benefit in favor of another beneficiary. However, such waiver would have to be exercised "on or before the close of the first plan year to which the amendments made by [REA] apply." The amendments made by REA apply first in the plan year that includes August 23, 1984. For most plans, this is the 1984 calendar year. Thus, the waiver opportunity will have elapsed before the Bill passes. We suggest extending this waiver opportunity to the end of the plan year in which REA is generally effective, *i.e.*, the first plan year beginning after December 31, 1984 (REA section 302(a)) or, for a collectively bargained plan, the first plan year beginning on or after the earlier of: (1) the expiration of the last collective bargaining agreement relating to the plan; or (2) January 1, 1987 (REA section 302(b)). This is appropriate since the waiver right will only be necessary if the participant died in the period between enactment of REA and its general effective date.

The proposed language also protects waiving spouses from gift taxes and from the anti-alienation provisions of ERISA and the Internal Revenue Code. However, it leaves open the possibility that a spouse waiving his or her REA rights in favor of a designated beneficiary might be subject to income tax on the money as an assignment of income. The statutory language or legislative history should make clear that this is not the case.

The legislative history should also note that a settlement of a disputed claim to benefits is not a waiver and would not entail any adverse tax consequences that might otherwise be associated with a waiver.

3. Qualified Domestic Relations Orders ("QDROs")

A. LIMIT ON QDRO PAY-OUTS

REA allows an ex-spouse to receive benefits, under a QDRO, even if the employee is still working. It enacted a special rule protecting the qualified status of pension and 401(k) plans that pay benefits, under these special circumstances, before the participant terminates employment.

Section 2(c)(4)(A)(v) of the Bill would amend Code section 414(p). It would apparently permit a qualified pension or 401(k) plan to make payments to an exposure while the employee is still working only if the present value of the payment is no more than $3,500.

We can see no justification for subjecting ex-spouses to such hardship with respect to benefits a court has ordered paid (and which REA may otherwise require). There is no reason why an individual entitled to a reasonable pension from his or her ex-spouse's plan should be forced to wait until that ex-spouse terminates employment. Indeed, in many cases, these benefits will be indispensable to the spouse's continued adequate support.

It is also unclear what benefits would be counted in determining whether the $3,500 limit is satisfied. The proposed language could be construed to count all of the payments that the ex-spouse is expected to receive before the employee terminates employment. Alternatively, it could be construed to count the total payments to which the ex-spouse is entitled.

We note that some plans have already started paying ex-spouses under QDROs without regard to the $3,500 limit. Thus, additional problems will be created because the proposed effective date of the change is January 1, 1985, the effective date of REA's QDRO provisions.

B. SERVICE OF QDROS

The Bill should also include a provision stating that a QDRO (or a non-qualified order) cannot affect any actions taken by a plan before a copy of it is delivered to the plan. For example, a plan that has not received a copy of a QDRO should be permitted to rely on a spousal sign-off, even if the QDRO gives the prior spouse a right to death benefits. It is obviously unfair and unworkable to require a plan to comply with a QDRO it has not received.

4. Spousal Consent To Use Plan Assets as Security for Loans

Section 2(b)(4) of the Bill would require spousal consent to the use of a participant's accrued benefit as security for a loan. This requirement would be effective for loans made after April 18, 1985.

April 18, 1985 has already passed, and plans have since been making loans without obtaining such spousal consent. Further, after REA and the DRA, plan managers have a great many other amendments to adopt, forms to revise, and other demands on their time. Accordingly, plans should be given a reasonable period prior to effectiveness of this requirement to enable them to make necessary preparations. We suggest January 1, 1986 as a reasonable effective date.

NATIONAL HOUSING LAW PROJECT,
Berkeley, CA, May 29, 1985.

Re § 102(a)(2) Technical Corrections Act of 1985 S. 814, H.R. 1800.

JOSEPH K. DOWLEY,
Chief Counsel, House of Representatives, Committee on Ways and Means, Washington, DC.

DEAR MR. DOWLEY: This testimony is submitted by the National Housing Law Project on the behalf of the following tax-exempt nonprofit organizations, which are actively involved in the development and preservation of low-income housing:

Jubilee West, Oakland, California.
Madison Mutual Housing Association, Madison, Wisconsin.
Orange County Community Housing Corporation, Santa Ana, California.
St. Vincent De Paul Society of San Francisco, California.
Womens' Development Corporation, Providence, Rhode Island.

Since 1968, the National Housing Law Project has been a resource center on housing matters for attorneys and others who represent poor people throughout the country. As a resource on housing matters, we have been intimately involved in

both the implementation and enforcement of existing housing policies and the development of new programs and policies on both the state and federal levels. Our activities include providing assistance to Legal Services attorneys throughout the country on housing problems their clients regularly encounter, as well as seeking to strengthen the clients' rights to decent housing in Congress, at HUD and the Farmers Home Administration, with state and local governments, and in the courts. From this experience of over 17 years, we have gained an extensive body of knowledge regarding the housing needs of poor people and the actual workings of the federal programs.

Since 1981, we have developed expertise as to the federal tax aspects of low-income housing by advising and representing nonprofit housing developers who have wished to use investor syndication capital to assist them in bulding or maintaining low-income housing. From that background we offer the following suggestions to your committee.

Section 102(a)(2) of the Technical Corrections Act of 1985 would severely restrict our client's ability to raise investor capital to build, maintain or rehabilitate low-income housing via partnerships which are structured to insure that the syndicated housing remains available at affordable rents to low-income people.rovisions of Internal Revenue Code § 168(j)(4)

The thrust of proposed § 102(a)(2) is to apply the anti-abuse provisions of Internal Revenue Code § 168(j)(4) (all citations are to the Internal Revenue Code) to partnerships with taxable and tax-exempt partners which are subject to § 168(j)(9). We believe that this proposed expansion is not a technical change both because it was not proposed during the legislative process which led to the Tax Reform Act of 1984 and because it is not necessary to remedy the problem which § 168(j)(9) was enacted to correct.

The following example illustrates the type of venture our clients often participate in:

A is a nonprofit organization which is exempt from federal income tax. A owns and operates H which is a low-income housing project. To raise capital to build additional housing A sells H to P, a limited partnership set up to operate H as low-income housing, P's managing general partner is B. B is a *taxable* nonprofit organization whose purpose is to operate low-income housing. B's directors are appointed on an on-going basis by A. B holds an "unqualified allocation" under § 168(j)(9) because it has a 1% allocation of P's operational income or loss but a 25% allocation of P's gain arising from the sale of H.

A established B to insure that H remains low-income housing both while owned by P and, if economically possible, when H sells P. A and B expect that B will be taxed as to any gain it may realize and that it will use any after-tax dollars to develop and preserve low-income housing.

Under the Tax Reform Act of 1984 B's unqualified allocation of gain was not within the scope of § ¶168(j) because B was not tax-exempt and the provisions of § 168(j)(4)(E) did not impute tax-exempt status to B. Additionally, the Tax Reform Act of 1984 did not apply related party rules to partnerships. Thus, a taxable subsidiary or affiliate of a tax-exempt organization did not have tax exempt status imputed to it merely because of a relationship to a tax-exempt organization.

Under the changes proposed by the Technical Corrections Act both B and P, who are engaged in operating low-income housing, may be successors under § 168(j)(4)(E)(iii) to A, which also operates low-income housing. Neither the statue, its legislative history, nor other provisions of the Internal Revenue Code indicate what relationship must exist between organizations which, when combined with "engaging in activities substantially similar" in nature, results in predecessor/successor relationship between those organizations. For the sake of discussion we will assume that B is such a successor, under § 168(j)(4)(E)(iii), to A, but that P is not. Becuase B is a successor it succeeds to A's treatment under § 168(j)(4)(E)(i), which is to be treated as a tax-exempt entity. The effect of this recharacterization is as follows.

Twenty-five percent of H is now, under § 168(j)(9)(c)(ii), treated as "tax-exempt use property" with a 40–year useful life for depreciation purposes. This recharacterization will reduce the amount of equity which investors will be willing to invest in P, and corespondingly, the amount of cash available to P to pay to A as part of the purchase price of H. This is the result despite the fact that B is both fully taxed on all income it realizes as P's managing general partner and that this income does not inure to A's benefit. Additionally, the overall federal tax paid by B's partners is increased by the reduction in its depreciation deductions but again there has been no corresponding benefit to A or any other tax-exempt entity.

The illogical nature of results which would flow from the proposed change become clearer when these results are contrasted with a virtually identical scenario. If we

assume that B is tax-exempt but that its involvement in P constitutes an unrelated trade or business, §168(j)(3)(D) makes it clear that the partnership is outside the scope of § 168(j). There is no logical reason why the result should be different if B is a taxable successor to a tax-exempt entity. In short, § 102(a) of the Technical Corrections Act seems to be a solution without a problem. This conclusion is confirmed when one considers that § 168(j)(9) was enacted to prevent the use of partnership allocations which direct all distributable cash to tax-exempt partners and all tax losses to the taxable partners in the same partnership. Section 168(j)(9) already effectively remedies that situation.

As detailed above, it is unclear at what tax system abuses the changes proposed at § 102(a)(2) of the Technical Corrections Act of 1985 are aimed. However, if the Congress wishes to enact § 102(a)(2) as proposed we request that it also take the following steps: 1. Define the relationship between organizations necessary to a finding of successor/predecessor status under § 168(j)(4)(E)(iii); 2. Define what is a "substantially similar activity" with particular emphasis on what portion of the organization's activities must be comparable and whether unrelated business activities are included in the analysis; and 3. Consistent with §168(j)(3)(D), provide for an irrevocable election by a tax-exempt entity, binding on its assignees and transferees, to treat all income, derived through its participation in a partnership, as unrelated trade or business income taxable under § 511. This election would allow a tax-exempt organization to participate in a commercial undertaking such as P without establishing a taxable affiliate or subsidiary.

These steps would clarify how, and at what tax cost, tax-exempt organizations might utilize taxable commercial undertakings that assist them in fulfilling their tax-exempt goals and purposes while insuring that any economic benefit derived from such undertakings would be fully subject to federal law.

Respectfully submitted,

RICHARD W. POWER,
National Housing Law Project.

STATEMENT OF HON. HAROLD HENRIQUEZ, MINISTER PLENIPOTENTIARY FOR NETHERLANDS ANTILLES AFFAIRS, GOVERNMENT OF THE NETHERLANDS ANTILLES

The Government of the Netherlands Antilles submits this statement for the record commenting on section 110(d)(2) of H.R. 1800, the "Technical Corrections Act of 1985," as section 110(d)(2) directly affects the Netherlands Antilles.

This section would amend the safe harbor for past years for U.S.-owned Netherlands Antilles international finance subsidiaries enacted as part of the section of the Deficit Reduction Act of 1984 repealing the U.S. withholding tax on portfolio interest paid to foreigners.[1] The safe harbor was designed to avoid U.S. Internal Revenue Service audit challenge of pre-existing Netherlands Antilles Eurobond issues meeting certain requirements as part of an effort to encourage such issues to remain in the Netherlands Antilles after repeal.[2]

Section 110(d)(2) would amend the safe harbor to make it applicable to foreign-owned Netherlands Antilles international finance subsidiaries as well as for U.S.-owned companies. However, the Netherlands Antilles must take strong exception to the proposed addition to the safe harbor denying affiliated U.S. borrowers U.S. tax deductions for the incremental interest charged by foreign-owned Netherlands Antilles international finance companies. This condition would undermine the Congressional purpose to moderate the repeal's serious adverse economic impact on the Netherlands Antilles and is also objectionable for the further reasons stated below.

CONGRESS INTENDED THAT EXISTING EUROBONDS STAY IN THE NETHERLANDS ANTILLES

In enacting the repeal legislation, the U.S. Congress was concerned about the inevitable negative consequences to the Netherlands Antilles international financial sector. This sector has depended to a substantial degree on Eurobond issuance activities by Netherlands Antilles international finance subsidiaries, and other investment into the U.S., conducted under the aegis of the income tax treaty between our

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[1] Pub. L. No. 98-369, § 127 (codified principally in sections 871(h) and 881(c) of the U.S. Internal Revenue Code). The safe harbor provisions are found in § 127(g)(3).

[2] As detailed below, other provisions designed to encourage issues to remain in the Netherlands Antilles were the effective date of repeal (obligations issued after enactment) and the effective date of the resourcing provisions for the U.S. foreign tax credit (1992 for certain issues outstanding on March 31, 1984 of Netherlands Antilles international finance subsidiaries).

two countries (the "Treaty"). The use of international finance subsidiaries located in the Netherlands Antilles developed and continued with the explicit or de facto support of the U.S. Treasury, as Deputy Assistant Secretary (Tax Policy) J. Roger Mentz observed in his testimony before this Committee. As the Netherlands Antilles has previously advised the U.S. Congress, its international financial sector is the single largest contributor to government revenues, accounting for 57% of the Netherlands Antilles Federal budget and 25% of the combined Federal and Curacao budgets.[3] Moreover this sector is a key source of foreign exchange—our means of importing the foreign goods and services on which we depend due to our limited natural resources—and provides substantial employment. Because of recent reverses in other basic sectors—such as the closing of the Exxon oil refinery in Aruba which is estimated to result both in a 35% decrease in Aruba's gross national product and a 25% increase in its unemployment; ongoing discussions concerning a reduced level of operations and employment at the only other refinery in our country, namely the Shell refinery in Curacao; and the continuing slump in tourism—the viability of the international financial sector is more crucial than ever to the Netherlands Antilles.[4]

To mitigate the economic hardship to the Netherlands Antilles stemming from the repeal, the Senate Bill would have provided a transitional incentive to new Eurobond issues through the Netherlands Antilles rather than by the direct U.S. route. On the other hand the Senate Bill would have permitted pre-enactment Eurobond issues by Netherlands Antilles international finance subsidiaries to be assumed by the U.S. parent companies. Thus while the Senate Bill sought to help the Netherlands Antilles by temporarily favoring new issues through the Netherlands Antilles, it permitted erosion of existing issues by assumptions.

Ultimately, the Congress chose a different approach to serve both the interests of promoting the direct access and softening the blow to the Netherlands Antilles—namely the repeal was made prospective only so that the old Eurobonds would continue in the Netherlands Antilles and not be removed through assumptions. This meant that the Netherlands Antilles international financial sector—which would lose the lion's share of the post-repeal Eurobond issuance business by reason of issuances directly from the U.S.—would still maintain the pre-repeal business, thereby mitigating somewhat the economic blow.[5]

Consistent with requiring Eurobond facilities to remain in the Netherlands Antilles, Congress modified the resourcing rules to ensure that U.S. parent companies would obtain U.S. foreign tax credits for Netherlands Antilles taxes on the grandfathered international finance subsidiaries' income from lending the proceeds of pre-repeal Eurobonds.[6]

To complete the third leg of the purpose to keep existing Eurobond issues in the Netherlands Antilles, Congress added the safe harbor—the subject of the correction proposed in section 110(d)(2). For 10 years up to 1974 the IRS issued favorable rulings sanctioning Eurobond issues through the Netherlands Antilles. Thereafter for

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[3] Tax Treatment of Interest Paid to Foreign Persons: Hearing on H.R. 3025 and H.R. 4029 Before the House Committee on Ways and Means, 98th Cong., 2d Sess. 118, 124-25 (May 1, 1984; Serial 98-84) (Statement of Dominico F. Martina, Prime Minister of the Netherlands Antilles). This hearing will hereafter be referred to as the "Repeal Hearing."

[4] Notably, the U.S. Treasury has acknowledged the severe result for the Netherlands Antilles involved in the repeal and has stated the object to ease that situation. At the May 1, 1984 hearing before this Committee, then Deputy Assistant Secretary (Tax Policy) Ronald A. Pearlman publicly stated in response to the concerns expressed about the effect on the Netherlands Antilles that Treasury's support for the repeal was "unrelated to the Netherlands Antilles or to the international finance subsidiaries." Repeal Hearing at 38. Mr. Pearlman went on to say, "We are sensitive to the problem of the Antilles. We would hope that through the continued treaty negotiations and through the other efforts that hopefully this Government would make in dealing with the Antilles, that the effect will be softened." Id.

[5] Although Congress therefore no longer saw the need to favor new issues through the Netherlands Antilles as under the Senate Bill, nevertheless it is fair to conclude that there was no intent or reason to stop companies from using the Netherlands Antilles as an alternative route for new Eurobond issues as long as U.S. companies have the option of direct access to the Eurobond market. Congress did see fit by means of the resourcing provisions to limit the availability of foreign tax credits with respect to Netherlands Antilles international finance subsidiaries, so that the choice of the Netherlands Antilles route would not provide a tax advantage over direct access, but did not otherwise act to dissuade companies from utilizing the Netherlands Antilles route or shut down other legitimate investment into the U.S. from the Netherlands Antilles international financial sector.

[6] Deficit Reduction Act of 1984, § 121(b)(2). It is noted that the exception to resourcing applies only in the case of certain Eurobonds outstanding on March 31, 1984, and expires January 1, 1992.

another 10 years Eurobond activity through the Netherlands Antilles continued on the basis of opinions of counsel with the de facto support of the U.S. Treasury (acknowledged by Deputy Assistant Secretary Mentz in his testimony before this Committee). When a technical concern about the creditability for U.S. tax purposes of the Netherlands Antilles tax paid by U.S.-owned international finance subsidiaries arose in 1980, the IRS published a ruling [7] to alleviate the concern and Netherlands Antilles issues continued. In very recent years, however, the IRS has made challenges on audit to alleged abuses of the Treaty. Thus Congress legislated the safe harbor to solve the pre-repeal audit cases as part of the package to keep pre-repeal Eurobond issues in the Netherlands Antilles.

PROPOSED WIDENING OF THE SAFE HARBOR—AVOIDING MISINTERPRETATION

The technical construction of the safe harbor enacted last year is such that it does not apply in the case of foreign-owned Netherlands Antilles international finance companies. Section 110(d)(2) would, along with the additional provision on deductibility discussed below, make the safe harbor apply in the foreign-owned case.

The Netherlands Antilles would like to state that in the event Congress decides to broaden the safe harbor provision, appropriate care should be taken not to leave the misimpression that, absent the safe harbor, the law would have been adverse to typical Netherlands Antilles structures. In legislating the original safe harbor provision, Congress made clear that no inference—one way or the other—should be drawn regarding the proper resolution of the other tax issues.[8] Similarly, should it be enacted the legislative history of section 110(d)(2) should confirm that the safe harbor as modified is not to be construed as reflecting on the merits in other cases.[9]

DENIAL OF DEDUCTIONS IS INAPPROPRIATE

Section 110(d)(2) as now defined would impose an additional condition on the availability of the safe harbor to foreign-owned Netherlands Antilles companies as compared to U.S.-owned companies. Namely, borrowing U.S. affiliates would be denied U.S. tax deductions for a portion of interest charges paid to foreign-owned Netherlands Antilles finance companies. The amount to be denied would reflect the "spread" between the interest rate charged to the U.S. affiliates and the interest rate at which the Netherlands Antilles company borrowed on the Eurobond market. For the following reasons the Netherlands Antilles protests the proposed condition, and strongly urges that the U.S. Congress reject it.

A. Denial of deductions conflicts with congressional intent

Denying U.S. affiliates' deductions conflicts with Congressional intent to keep existing Eurobond activities in the Netherlands Antilles by creating additional U.S. tax costs for foreign-owned affiliated groups maintaining pre-repeal facilities in the Netherlands Antilles. This denial of deductions would furthermore be paramount to disallowing future activities of international finance subsidiaries through the Netherlands Antilles which also conflicts with both Congressional intent and the intent

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[7] Rev. Rul. 80-4, 1980-1 C.B. 169.

[8] H.R. Rep. No. 98-861 (Conference Report on Deficit Reduction Act of 1984), 98th Cong., 2d Sess. 938 (1984).

[9] In October 1984 the IRS issued two revenue rulings holding that interest paid by U.S. subsidiaries of a Swiss and a U.S. parent, respectively, to a Netherlands Antilles subsidiary of that parent on certain obligations did not qualify for the Treaty exemption from the 30% U.S. withholding tax. Rev. Rul. 84-152, 1982-42 I.R.B. 9; and Rev. Rul. 84-153, 1984-42 I.R.B. 9, in which the Netherlands Antilles company had raised the funds for the loans to the U.S. affiliate in Eurobond offerings. These rulings signal an aggressive IRS audit stance on those cases not covered by the safe harbor. The consensus of the U.S. tax experts, and the view of the Netherlands Antilles, is that the rulings are overbroad and go beyond the legal precedents; the need for their clarification has been urged. E.g., Fogarasi & Renfroe, "Is the Benefit of the U.S.-Netherlands Antilles Treaty Terminated for Financing Companies?", 13 Tax Mgmt. Int'l. J., 442 (Dec. 1984); Fuller, Rev. Ruls. 84-152,-53 Captive Finance Companies," 60 Taxes Int'l. 74 (Oct. 1984); Guttentag, "IRS Discloses New Position Regarding Treaty Benefits," VII Can. L. Newsletter 55 (Jan. 1985). The Tax Committee of the United States Council for International Business also wrote to the IRS on January 18, 1985 expressing similar views.

Practical testimony to the weight of authority contrary to the thrust of Rev. Rul. 84-153 is that, based on opinion of counsel, some 200 U.S. corporations have used the Treaty since 1973 to issue over $34.5 billion in Eurobonds.

These rulings are also in conflict with the intent of Congress in enacting the "repeal legislation" since Congress clearly sought to create direct access for U.S. companies to the Euromarket and not to disallow access through the Netherlands Antilles. This intent of Congress is incidentally acknowledged by the Treasury Department as indicated in note 10.

of the U.S. Treasury Department. The purpose of intent of the repeal legislation was to provide U.S. companies direct access to the Eurobond market [10] not to deny access through the Netherlands Antilles.

B. Flawed rationale for denying deductions

The rationale stated for denying deductions in the foreign-owned case is to achieve parallel results to the subpart F inclusion of the spread income in the U.S.-owned case. This ignores, however, that by reason of the above-mentioned exception to the resourcing rules, U.S.-owned groups will generally continued to enjoy foreign tax credits for the Netherlands Antilles tax (at about a 30% rate) on the spread income attributable to lending pre-repeal Eurobond proceeds. These foreign tax credits will largely offset U.S. tax liability on the spread income.

Thus—far from placing foreign-owned companies on a parity with U.S.-owned companies—denying deductions for the spread *discriminates* against foreign-owned companies. These companies would end up with *double U.S. and Netherlands Antilles taxation of the same spread income.*

C. Denial of deductions contrary to tax norms

The Netherlands Antilles believes that denying deductions because foreign-owned groups are not subject to U.S. subpart F rules would in any event be contrary to international tax norms. Under those principles, deduction for interest paid an affiliate on an otherwise legitimate loan may be disallowed only to the extent an arm's length rate is exceeded.[11] There is no reason to assume that foreign-owned Netherlands Antilles international finance companies charged more than arm's length rates on pre-repeal loans of the proceeds of their Eurobond offerings, notwithstanding that the loan rates were in excess of the Eurobond rates.

Indeed the contrary seems obvious—that an arm's length rate must have included a spread over and above the Eurobond rate. Prior to the repeal U.S. borrowers could not have obtained loans at Eurobond rates from unrelated lenders. As a minimum, unrelated foreign lenders would have grossed-up the Eurobond rate by an amount to reflect the 30% U.S. withholding tax. Alternatively, rates available from unrelated U.S. lenders also would have greatly exceeded the Eurobond rates. Representatives of the U.S. securities industries have submitted data to Congress showing that during the period preceding the repeal the cost of funds in the U.S. domestic public market consistently exceeded Eurobond costs; this spread in costs often approached, and in cases surpassed, one percentage point.[12]

D. Denial of deductions inconsistent with treaty

In 1963 our two countries negotiated a Protocol to the Treaty. At the insistence of the U.S. the Protocol required that in order for foreign-owned Netherlands Antilles companies (other than wholly Dutch-owned companies) to be entitled to withholding rate exemption (or reduction) under the Treaty, the companies must pay Netherlands Antilles tax at full rates (about 30% in the case of interest income). The Netherlands Antilles must certify whether a company complies with the Protocol's requirement.

The Netherlands Antilles does not certify compliance unless a company agrees to a minimum spread in the case of loans of Eurobond proceeds.[13] Obviously in the absence of such agreement, the Protocol's purpose—that treaty-benefitted companies should bear a significant Netherlands Antilles tax—would be defeated.

The implication of the proposed denial of the deduction for the spread, however, is that the Netherlands Antilles should not be taxing this income.[14] This would mean that the foreign-owned companies would be enjoying the Treaty withholding tax exemption for the entire interest paid by the U.S. affiliate without bearing any Netherlands Antilles tax. This result—besides unfairly denying the Netherlands Antilles

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[10] Statement of J. Roger Mentz, Deputy Assistant Secretary (Tax Policy) before the House Committee on Ways and Means, May 16, 1985 (page 17 third paragraph).

[11] Organisation for Economic Co-operation and Development, Transfer Pricing and Multinational Enterprises 90-93 (1979). Under U.S. law this principle is codified in section 482 of the U.S. Internal Revenue Code.

[12] Repeal Hearing at 89-91 (statistics on cost savings in the Eurodollar bond market in 1982-83 compiled by the Securities Industry Association) and 287-288 (similar statistics for 1983 and first four months of 1984 submitted by Avon Products, Inc.).

[13] The U.S. has been aware of the Netherlands Antilles spread requirement and, in fact, has confirmed the appropriateness of the requirement in the context of ongoing discussions with the Netherlands Antilles.

[14] The alternative, already mentioned above, would be double taxation by both the Netherlands Antilles and the U.S.

an appropriate part of its tax base—would clearly be inconsistent with the 1963 Protocol.[15]

E. Denial of deductions is substantive not technical

Chairman Rostenkowski has stressed that this legislation should not become the vehicle for substantive changes and that a high definitional standard will apply to each proposed "technical" amendment. The denial of deductions for part of the interest paid to Netherlands Antilles finance companies was not included in the safe harbor provisions enacted in 1984. To deny deductions in this legislation would substantively change the tax rules that otherwise would govern past transactions without any basis for doing so in the original legislation, and so fails to meet the Chairman's standard.

In conclusion, the Netherlands Antilles strongly urges that Congress reject the provision denying deductions for the spread as contrary to Congressional intent, international tax norms, the Treaty and the purpose of the legislation.

NEW YORK STATE LEGISLATURE,
May 28, 1985.

Hon. DAN ROSTENKOWSKI,
House of Representatives, Washington, DC.

DEAR CONGRESSMAN ROSTENKOWSKI: We are taking this opportunity to provide you with our views regarding the effect of the proposed and temporary regulations on state volume caps for private activity industrial development bonds which are in apparent conflict with the Deficit Reduction Act of 1984 (P.L. 98-369) and to request corrective legislation on this issue. Our specific concern with these regulations is the extended "interim authority" provided to governors, which appears to contradict the express statutory intent found in DEFRA and to substantially and unnecessarily contravene New York's constitutional distribution of governmental power.

As enacted, DEFRA provides in pertinent part:

"(6) STATE MAY PROVIDE FOR DIFFERENT ALLOCATION.—

"(A) IN GENERAL.—A State may, by law provide a different formula for allocating the State ceiling among governmental units in such State having authority to issue private activity bonds.

"(B) INTERIM AUTHORITY FOR GOVERNOR.—

"(i) IN GENERAL.—The Governor of any State may proclaim a different formula for allocating the State ceiling among the governmental units in such State having authority to issue private activity bonds.

"(ii) TERMINATION OF AUTHORITY.—The authority provided in clause (i) shall not apply after the earlier of—

"(I) the first day of the first calendar year beginning after the legislature has met in regular session for more than 60 days after the date of the enactment of this paragraph, or

"(II) the effective date of any State legislation with respect to the allocation of the State ceiling (P.L. 98-369, § 621; 26 U.S.C. § 103(n)(6)).

In comparison, the regulation promulgated by Treasury implementing this provision provides: "The authority of the governor to proclaim a different formula shall not apply after the earlier of (i) the first day of the first calendar year beginning after the legislature of the State has met in regular session for more than 60 days after July 18, 1984, *and* (ii) the effective date of any State legislation dealing with the allocation of the State ceiling. *If, on or before either date, the Governor of any State exercises the authority to provide a different allocation, such allocation shall be effective until the date specified in (ii) of the immediately preceding sentence* (49 F.R. 39314, 39322, Oct. 5, 1984) [emphasis added]."

On its face, the governors' authority found in 26 U.S.C. § 103(n)(6)(B) is clear. The statutory provision regarding interim authority for governors was designed by Congress to meet the needs of those states whose legislatures don't meet in regular session or are restricted by their own state constitutions to legislative sessions of limited duration. Indeed, certain state legislatures throughout the nation meet only once biennially. If a state legislature finished its business for an extended period of time prior to the enactment of DEFRA, without the interim authority provided to the

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[15] The Netherlands Antilles notes that the practice of companies under the existing safe harbor has already pinched the Netherlands Antilles tax base. In the past companies typically maintained a 3 to 1 or lower debt-equity ratio. However, the safe harbor adopted in the 1984 legislation permits a 5 to 1 ratio. Many companies are taking advantage of this latitude at the expense of the Netherlands Antilles revenue.

governor by the Act, that state could only use the allocation found in 26 U.S.C. § 103(n)(2),(3), irrespective of the needs of state and local issuing agencies. The construction of the statutory provisions pertaining to interim authority as enacted is patently a temporary grant of power allowing governors to act when state legislatures are constitutionally prohibited or otherwise unable to meet.

In contradistinction, the proposed Treasury regulation turns this statute into an absolute grant of power to governors throughout the nation. If this regulation is not superseded by Congress and becomes final in its present form, it will have a double-barreled negative effect on states. This regulation has the effect of turning temporary executive orders as envisioned by Congress into ad infinitum proclamations, since a governor could veto legislation if it was not in absolute accord with the executive order, and thus force a veto override requiring a supermajority, or in New York's case a two-thirds majority which is always difficult, if not impossible to muster. The regulation, although inadvertently, impairs the traditional relationship between the executive and legislative branches of state government by vesting in the executive authority normally delegated to legislatures—the power to pass laws. The interpretation by the Treasury Department in this particular instance skews existing relationships and preempts state constitutions without a demonstrated national need.

Moreover, the Treasury Department's regulation changes the "or" found between (I) & (II) in 26 U.S.C. § 103(n)(6)(b)(ii) to an "and" which only further obfuscates Congressional intent. The "earlier of" statutory language, when read in conjunction with the "or" between the two alternatives, contemplates one of two possibilities. The Treasury Department's "and" in its regulation neither reflects Congressional intent nor makes any sense.

At this juncture we must note that the Treasury Department issued virtually the same regulation (26 C.F.R. § 6a 103 A-2(g)(9)) pursuant to a similar statutory provision found in the Mortgage Subsidy Bond Tax Act of 1980 (P.L. 96-499). Had we focused on this provision of the regulations under the 1980 Act, we would have voiced the same objections then. However, New York, through a legislative enactment (Ch. 883 L. 1980, § 92, Nov. 26, 1980) allocated its mortgage subsidy bonds prior to the issuance of those Federal regulations (46 F.R. 34314, July 1, 1981), making the matter moot at the time. This bad precedent is best abandoned rather than followed.

As Majority Leader of the Senate and Speaker of the Assembly in New York, we respectfully request that during your current deliberations on technical amendments to DEFRA, you rectify this egregious interpretation of Congressional intent made by Treasury, to ensure statutory distributions of private activity industrial development bond authority in states throughout the nation.

Sincerely,

WARREN M. ANDERSON,
Majority Leader, The Senate.
STANLEY FINK,
Speaker, The Assembly.

STATEMENT OF ROBERT F. SCHOENHOFER, EXECUTIVE DIRECTOR, NORTHEAST MARYLAND WASTE DISPOSAL AUTHORITY

I am Robert F. Schoenhofer, Executive Director of the Northeast Maryland Waste Disposal Authority. I am submitting this testimony because the Authority believes that Congressional clarification is needed so that a "Federal guarantee" provision in the tax-exempt bond sections of the 1984 Tax Act is not incorrectly applied to proscribe the financing of either the Harford County/Aberdeen Proving Ground or the Annapolis/U. S. Naval Academy waste-to-energy facilities. The Authority seeks an amendment to the Technical Corrections Act of 1985 essentially in the form of recently introduced HR 1767 which I have attached to my testimony.

The projects will be financed by the Northeast Maryland Waste Disposal Authority. The Authority is a public instrumentality of the State of Maryland formed on July 1, 1980 in order to develop regional solid waste disposal projects. Over the past four years, the Authority has expended approximately $850,000 to develop the Harford County Waste-to-Energy Facility. The Authority has substantially completed its development activities and the project can be financed and construction commenced this year. The facility would provide Harford County and the Aberdeen Proving Ground with a long-term, environmentally sound solution to their solid waste disposal needs and will produce steam for sale to the Army's Aberdeen Proving Ground pursuant to a long-term contract. It is anticipated that the Army will save

over 3.5 million gallons of oil each year as a result of its use of steam generated from solid waste.

The Authority has also been developing the Annapolis Waste-to-Energy Facility during approximately the last three years, has expended approximately $250,000 in the process and has purchased land to be used as a site for the facility. The Annapolis facility would provide the City of Annapolis, Anne Arundel County, Queen Anne's County, and the Naval Academy with a long-term solution to their solid waste disposal needs and provide the Naval Academy with a reliable source of steam which would allow the Navy to save the equivalent of 3 million gallons of fuel oil annually.

It should be noted that the military procurement authorization laws in recent years have expressed Congress' intent that third party financing and ownership of energy facilities, including waste-to-energy, be encouraged and that direct federal appropriations be used only when that alternative has been exhausted. The Harford County and Annapolis projects have been the subject of thorough negotiation and hard bargaining with the Army and Navy.

In the course of developing new restrictions on tax-exempt bonds, the Congress focused on certain transactions in which federal agencies provide the security for tax-exempt bonds through guaranteeing the obligations, such as a transaction where bond proceeds are deposited in banks or savings and loans to be loaned to the bond user. Under this arrangement, the bond holders, in effect, were insured by the FDIC or the FSLIC. There are other federal programs run by agencies such as the SBA, HUD, the FHA and the VA in which the federal government also pledges or guarantees the repayment of bonds by other parties although no service is provided to the federal government. The tax-writing committees were concerned that a special subsidy was being provided in these cases creating a favored class of obligation.

The Authority currently has a ruling request pending with the IRS concerning the tax-exemption of bonds to be issued for the Harford facility. The IRS has indicated that it cannot give the project a favorable ruling because of the fact that revenues from the long-term steam sales with the U. S. Army, which may be available to the operator of the Harford facility to pay debt service on the bonds, may constitute a Federal guarantee. Had the Authority known that the IRS would take this position, it would have requested an exemption for its two projects in the 1984 Tax Act as several other projects did successfully at that time.

The energy contracts with the military contain provisions under which the military base pays for certain minimum quantities of energy if and only if the energy is made available by the energy supplier. This type of arrangement is necessary for the financial security of any project. The provision is not a guarantee of the principal and interest on the bonds but is simply a contractual commitment to pay for certain minimum quantities of energy in consideration for receiving access to a secure supply. This is not a "hell or high water" provision which requires government payments even if a facility is not built or energy is not available. Nor is a special bond class created. This type of provision does not cause the bonds to receive a higher credit rating than they otherwise would receive.

It is anticipated that all of the steam from the Harford facility will be sold to the Aberdeen Proving Ground and that the proceeds of the steam sales, together with waste disposal fees paid by Harford County, will be used to pay the operating expenses of the Harford facility, including debt service on the bonds. The Army, however, is not obligated to make payments under the steam purchase contract unless steam is produced and made available to it. Because of the real business risks which could prevent the facility operator from providing steam to the Army, the payment of the principal and interest on the bonds is by no means guaranteed by the Federal government. A similar steam purchase contract is being negotiated with the Navy for the purchase of substantially all of the steam from the Annapolis facility.

According to the general explanation of the 1984 Tax Act prepared by the Staff of the Joint Committee on Taxation: "Congress intended that the determination of whether a federal guarantee exists be based on the underlying economic substance of the transaction, taking into account all the facts and circumstances in this regard. A transfer or risk to the Federal government is a key element in determining whether such a guarantee exists." Under the Aberdeen Proving Ground and Naval Academy contracts, financial, technological and operating risk of loss, other than that covered by premature termination by the government, lies with the project. Under the 1984 Tax Act's special service contract rules for solid waste disposal facilities, the service recipient (military base) cannot bear significant financial risks. The projects intend to comply fully with the special service contract rules.

In order to permit the financing of the Harford County and Annapolis facilities, the Authority requests clarification that the Federal guarantee provisions do not

apply the bonds for these projects. Immediate action is necessary so that both of these worthwhile projects can move forward without substantial delay which will as a practical matter prevent their development.

STATEMENT OF LEE GOODMAN, JR., OGM PROPERTIES

My name is Lee Goodman, Jr. I am one of three general partners in OGM Properties, a Texas general partnership. The business of the partnership is real estate development, and we have a number of projects located in the State of Missouri. Six of our properties in Missouri are long-term-care nursing homes which were financed with the proceeds of industrial development revenue bonds issued by various issuers in the State of Missouri. Further details of these six bond issues are as follows:

IDA issuer	Principal amount	Approximate interest rate, percent	Month of closing
Pemiscot Co.	$1,850,000	15	July 1981.
Jefferson Co.	1,850,000	15	August 1981.
City of Waynesville	1,850,000	16.75	November 1981.
Cape Girardeau	2,200,000	16.25	December 1981.
City of Brookfield	1,850,000	16.25	December 1981.
City of Sullivan	1,960,000	16.50	March 1982.

All of these facilities are open and operating. However, the interest rates accruing on the bond issues are extremely high, reflecting the tight credit markets of 1981. As we approached the time when these issues became subject to optional redemption, we employed bond counsel and other advisors to examine the availability of refunding bonds as a means of refinancing these facilities at a lower interest rate.

On April 29, 1984, our attorneys made initial contact with the six issuers to ascertain their willingness to issue bonds for the purpose of refunding the outstanding bond issues. All six gave affirmative responses.

On June 6, 1984, bond counsel began legal research on the various requirements for such refinancings, and on June 14, 1984, traveled from Atlanta, Georgia, to Memphis, Tennessee, to meet with Union Planters Bank about the availability and terms of possible financing. From that time until early January, 1985, very little work was done on the refundings. On January 15, 1985, research was conducted to determine the various effective dates of the provisions of the Tax Reform Act of 1984, especially with respect to the aggregate limitation of $40,000,000.00 on the small issue exemption with respect to any owner or principal user of the facilities being financed by an issue. Our major concern here arose from the fact that the lessee of four of the six nursing homes is Beverly Enterprises, Inc., and the aggregate face amount of all outstanding tax exempt industrial development bonds which would be allocated to Beverly Enterprises, Inc. pursuant to I.R.C. §103(b)(15) as adopted on June 27, 1984, would be in excess of $40,000,000.00. Therefore, the availability of tax-exempt refunding for these four homes would depend in part on the effective date of I.R.C. § 103(b)(15).

Section 103(b)(15) was added to the Internal Revenue Code by Section 623 of the Tax Reform Act of 1984 (the "Tax Reform Act"). The effective date of this provision is governed by Section 631(c) of the Tax Reform Act, and in particular Section 631(c)(3)(A):

> (A) CONSTRUCTION OR BINDING AGREEMENT.—The amendments made by [section 623] shall not apply to obligations with respect to facilities (i) the original use of which commences with the Taxpayer and the construction, reconstruction or rehabilitation of which began before October 19, 1983, or (ii) with respect to which a binding contract to incure significant expenditures was entered into before October 19, 1983.

Relying on the clear language of the statute, and having increased confidence because of the fact that the construction of the facilities was completed before October 19, 1983, we began a full scale effort toward consummating the six refundings.

On January 15, 16, and 17, 1985, bond counsel traveled from Atlanta, Georgia, to the six issuers' locations to oversee passage of Inducement Resolutions for each refunding issue of tax-exempt industrial development bonds. On February 6, 1985, bond counsel began a review of commitments from Community Federal Savings & Loan Association (St. Louis, Missouri) and Union Planters National Bank (Memphis, Tennessee) regarding a guarantee of the payment of principal and interest on the

bonds and the underwriting of the bonds. On February 11, 1985, initial contact was made with the State of Missouri concerning the State's system for allocating private activity bond issue capacity, and on February 13, 1985, initial drafting of documents for the six refinancings was begun by bond counsel in Atlanta, Georgia.

Drafting continued throughout the remainder of February and until March 27th, when a document session was held in St. Louis, Missouri, among bond counsel, OGM's counsel, Community Federal's counsel and representatives of Union Planters. In early April, 1985, bond counsel from Atlanta, Georgia, traveled to Fort Worth, Texas, and Kansas City, Missouri, to examine records of the trustees for each of the six outstanding bond issues.

By the second week of April, 1985, we had incurred over $102,000.00 in legal fees and over $12,000.00 in expenses as a result of work toward the refunding of all six bond issues.

On April 17, 1985, tax reporting service material contained H.R. 1800, the Technical Corrections Act of 1985, and immediately work on four of the six issues was halted. The four refunding issues have been postponed indefinitely as a result of the current proposed language of Section 169(a)(2)(B), the Technical Corrections Act, which language provides that:

> B. Effective with respect to obligations issued after March 28, 1985, subparagraph (a) of Section 631(c)(3) of the Tax Reform Act of 1984 is amended by striking out clauses (i) and (ii) and inserting in lieu thereof the following:
>
> (i) the original use of which commences with the taxpayer and the construction, reconstruction or rehabilitation of which began before October 19, 1983, and was completed on or after such date, or
>
> (ii) with respect to which a binding contract to incur significant expenditures for construction, reconstruction, or rehabilitation was entered into before October 19, 1983, and some of such expenditures are incurred on or after such date.

If enacted in its present form, this amendment would impose the further condition that construction of the facilities must have been completed after October 18, 1983, in order for the "construction or binding agreement" exception of Section 631(c)(3)(A) of the Tax Reform Act to apply to obligations issued after March 28, 1985. Under those circumstances, the "construction or binding agreement" exception to the effective date of the $40,000,000.00 aggregate limit per taxpayer restriction on the small issue exemption would no longer apply to the refunding issues, because the construction of the four nursing homes was completed prior to October 19, 1983, and, therefore, the refunding issues would be taxable due to the volume of outstanding tax-exempt industrial development bonds allocable to Beverly Enterprises, Inc.

In light of the explicit conditions originally set forth in Section 631(c)(3)(A) of the Tax Reform Act, and in view of the reliance of the Borrower on that exception in arranging refunding issues offering both lower interest rates and lower principal amounts, the retroactive effect of Section 169(a)(2)(B) of the Bill as currently proposed is inequitable, burdensome and unwarranted. The language of the proposed amendment itself recognizes the undesirability of retroactivity when it excepts obligations issued before March 28, 1985. This exception, however, is insufficient to protect the Borrower, whose refunding bonds were scheduled to be issued in April, May and June, 1985.

One cannot deny or ignore the highly inequitable effect of a retroactively adopting a "technical correction" which introduces a limitation which could not have been inferred from the original statute or legislative history when we have expended substantial sums of money and devoted the better part of one year trying to refund the Issues under current law.

We urge the House Committee on Ways and Means to amend the special effective date provision of the Bill. As presently written, Section 169(a)(2)(B) of the Bill would affect obligations issued after March 28, 1985. We proposed that Section 169(a)(2)(B) of the Bill not apply to obligations for which inducement resolutions were adopted prior to March 28, 1985, where substantial expenditures are made in reliance upon such inducement resolutions, and where the bonds are issued prior to January 1, 1986.

MEMORANDUM

Re 10599/35159 effective date provisions of aggregate limit per taxpayer exception.
Date: February 15, 1985.
To: Bob Young.
From: Terry Greene.

Code § 103(b)(15), added by section 623 of the Deficit Reduction Act of 1984, P.L. No. 98-369 (the "Act"), provides that Code § 103(b)(6), the small issue exception, shall not apply to any issue if the aggregate authorized face amount of such issue allocated to any test-period beneficiary, when increased by the outstanding tax-exempt IDBs of such beneficiary, exceeds $40,000,000. Code § 103(b)(15)(B) specifies that any obligation which is to be redeemed from the proceeds of the issue under consideration is not taken into account in determining the outstanding tax-exempt IDBs of any person. In addition to providing a counting rule for purposes of the $40,000,000 limit, this provision indicates that the limit is intended to apply to refunding issues as well as new money issues, and further indicates that the proceeds of a refunding issue are deemed to be used to finance the facility which was financed by the obligations to be refunded.

The aggregate limit per taxpayer for the small issue exception is generally effective for obligations issued after December 31, 1983. Act § 631(c)(1). Although the Act does not specifically mention refunding bonds in this context, the legislative history indicates that the general rule is that the aggregate limit per taxpayer restriction applies to obligations including refunding obligations issued after December 31, 1983. H.R. Rep. No. 98-432, 98th Cong., 2d Sess. 1698 (1984) (hereinafter cited as the "House Report"). Two exceptions to the aggregate limit per taxpayer restriction are provided by the Act. First, the restriction does not apply to obligations for which an inducement resolution (or other comparable preliminary approval) was adopted before June 19, 1984, if the obligations are issued before January 1, 1985. Act § 631(f). Second the restriction does not apply to obligations with respect to facilities—

(i) the original use of which commences with the taxpayer and the construction, reconstruction or rehabilitation of which began before October 19, 1983, or

(ii) with respect to which a binding contract to incur significant expenditures was entered into before October 19, 1983.

Act §631(c)(3)(A). Section 631(c)(3)(B) of the Act provides that "Subparagraph (C) of subparagraph (b)(2)(A) shall apply for purposes of subparagraph (A) of this paragraph." This erroneous citation was not corrected in H. Con. Res. 328, which made other technical corrections to the Act. It is apparent, however, that Act § 631(b)(2)(C), a definition of "facilities," is intended to apply for purposes of Act § 631(c)(3)(A).

Act § 631(b)(2)(C) provides that:

In the case of an inducement resolution or other comparable preliminary approval adopted by an issuing authority before October 19, 1983, for the purposes of applying subparagraphs (A)(i) and (B)(ii) with respect to obligations described in such resolution, the term "facilities" means the facilities described in such resolution.

In addition to this definition of "facilities," the Act also provides a definition of "significant expenditures" for purposes of § 631 of the Act which establishes a minimum level equal to the lesser of $15,000,000 or "20 percent of the estimated cost of the facilities." Act § 631(e).

For purposes of the inducement resolution exception and the construction or binding agreement exception to the general effective date of Act § 631(c)(1), "the determination of whether an inducement resolution . . . was adopted, of whether the taxpayer was the original user or construction had commenced before a specified date, of whether significant expenditures were made, or of whether a binding contract existed is made in the same manner as that used under rules on the State volume limitation." Staff of Joint Committee on Taxation, 98th Cong. 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 at 955 (Comm. Print 1985) (hereinafter referred to as the "General Explanation").

The proposed refunding issues will be issued after December 31, 1983, and will therefore be subject to the aggregate limit per taxpayer restriction unless an exception applies. The exception contained in Act § 631(f) will not apply because the proposed refunding issues will be issued after December 31, 1984, and because there was no inducement resolution or other comparable preliminary approval for the refunding issues before June 19, 1984. The exception contained in Act § 631(c)(3)(A), however, will permit the proposed refunding issues to avoid the aggregate limit per taxpayer restriction.

The first requirement of the construction or binding agreement exception contained in Act § 631(c)(3)(A) is that the proposed refunding issues must constitute "obligations with respect to facilities" described in that subparagraph. The construction or binding agreement exception does not specifically mention refunding bonds. Nevertheless, the general treatment of refunding bonds under Code §103 and the specific treatment of refunding bonds in the context of the aggregate limit per taxpayer restriction, as well as the treatment of refunding bonds in other provisions of the

Act, require the conclusion that refunding bonds may constitute obligations with respect to facilities described in Act § 631(c)(3)(A).

The aggregate limit per taxpayer restriction requires an allocation of the face amount of a proposed issue to each "test-period beneficiary," defined as any owner or principal user of facilities being financed by the issue. The inclusion of a special rule to avoid double counting in the case of a refunding issue makes it clear that this restriction applies to refunding issues as well as new money issues. Because the face amount of the refunding issue must be allocated to each owner or principal user of the "facilities being financed by such issue," the restriction itself demonstrates that refunding issues constitute "obligations with respect to facilities" and not merely obligations with respect to a prior issue of obligations or some other characterization that would preclude reliance on the construction or binding obligation exception.

The characterization of a refunding issue as "obligations with respect to facilities" is also required by Code § 103(b)(6), which imposes a separate set of counting rules for purposes of determining eligibility for the small issue exemption. The applicability of these counting rules to refunding issues is explicitly required by clause (ii) of Code § 103(b)(6)(A). Pursuant to Code § 103(b)(6)(B), the outstanding face amount of a prior issue is aggregated with the face amount of a later issue if the proceeds of such issues "are or will be used primarily with respect to facilities" described in that subparagraph. A special provision prevents double counting in the case of refunding issues by not including as outstanding any obligation which is to be redeemed from the proceeds of the later issue. Accordingly, because Code § 103(b)(6) requires a determination of whether the proceeds of a refunding issue and prior issues (other than the issue to be refunded) are or will be used primarily with respect to facilities described in Code § 103(b)(6)(B), the refunding issue must be considered "obligations with respect to facilities" and not merely obligations with respect to a prior issue of obligations or some other characterization that would preclude reliance on the construction or binding contract exception.

This interpretation is also required by the regulations under Code § 103. Reg. § 1.103-7(d)(1) provides that "the proceeds of the refunding issue will be considered to be used for the purpose for which the proceeds of the issue to be refunded were used." Moreover, this rule applies "regardless of the date of issuance of the issue to be refunded." *Id.* Consequently, a refunding issue will constitute obligations with respect to the facilities with respect to which the obligations to be redeemed were issued.

Although the construction or binding agreement exception does not specifically mention refunding bonds, this omission is consistent with the general scheme of amendments to Code § 103, which provide special rules for refunding bonds in cases where special treatment is intended. In other words, the absence of a special effective date provision for refunding bonds indicates that the construction or binding obligation exception is intended to apply to refunding bonds as well as new money issues.

The general effective date provision of Act § 631(c)(1), for example, states that most of the amendments to Code § 103 made by the Act apply to obligations issued after December 31, 1983, but does not provide a special rule for refunding bonds. Accordingly, such amendments apply to all obligations, including refunding obligations, issued after December 31, 1983. *See* House Report at 1698.

Act § 631(b), on the other hand, does provide special effective dates for refunding bonds in the case of new restrictions on cost recovery deductions for property financed with industrial development bonds. The restrictions on cost recovery deductions generally apply to property placed in service after December 31, 1983, to the extent such property is financed by the proceeds of an obligation issued after October 18, 1983. Two special rules for refunding bonds are provided in Act § 631(b)(2)(B). First, if property placed in service after December 31, 1983, is financed by the proceeds of an obligation which is issued solely to refund another obligation issued before October 19, 1983, the new restrictions on cost recovery deductions apply only to the extent of the unrecovered basis in such property on the date such refunding obligation is issued. Act § 631(b)(2)(B)(i). Second, in the case of facilities the original use of which commences with the taxpayer and with respect to which significant expenditures are made before January 1, 1984, the new restrictions on cost recovery deductions do not apply with respect to such facilities to the extent and facilities are financed by the proceeds of an obligation issued solely to refund another obligation which was issued before October 19, 1983. Act § 631(b)(2)(B)(ii).

In the case of the restrictions on cost recovery deductions, special effective date provisions for refunding bonds were necessary in order to provide that a refunding issue will not be treated as a new issue (and, therefore, accelerated cost recovery

methods may be used) if significant expenditures were made with respect to the facility before January 1, 1984, and the original use of the facility commences with the taxpayer, and in order to provide that only the remaining unrecovered cost is required to be recovered using the slower method and period in the case of other refunding issues (so that no retroactive adjustments to cost recovery deductions previously claimed are required upon a refinancing of a pre-October 19, 1983 issue). A similar need for special refunding bond provisions is not apparent in the case of the amendments to which Act § 631(c) applies.

In addition, the language of Act § 631(b) further supports the conclusion that refunding bonds constitute obligations "with respect to facilities" within the meaning of Act § 631(c). The special refunding bond provisions of Act § 631(b) both refer to facilities "financed by the proceeds of an obligation issued solely to refund another obligation," further indicating that refunding bonds are considered obligations with respect to the facilities with respect to which the obligations to be refunded were issued.

The general rule of Act § 631(b)(1), however, does specifically refer to "an obligation (including a refunding obligation) issued after October 18, 1983." Neither the general rule of Act § 631(c) nor the construction or binding obligation exception includes a similar parenthetical phrase. The absence of this phrase cannot be controlling, however, because it is absent form both the general rule of Act § 631(c) and the construction or binding obligation exception, as well as other effective date provisions for amendments to Code § 103 which were clearly intended to apply to both refunding bonds and new money issues. *See, e.g.,* P.L. 97-448, § 306(b)(2) (obligations issued after June 30, 1983 required to be in registered form to be tax-exempt). The presence of this phrase in Act § 631(b)(1) must therefore be construed as a clarification which does not change the meaning of the sentence in which it appears. *See, e.g.,* Code § 103(b)(6)(N).

Having determined that the proposed refunding bonds will constitute obligations with respect to the facilities with respect to which the obligations to be refunded were issued, the remaining question is whether those facilities are described in Act § 631(c)(3)(A). Assuming that the original use of each facility commenced with the taxpayer and that the construction of each facility began before October 19, 1983, the refunding issues will qualify as obligations with respect to facilities described in clause (i) of Act § 631(c)(3)(A). Assuming that binding contracts to incur significant expenditures with respect to such facilities were entered into before October 19, 1983, the refunding bonds will qualify as obligations with respect to facilities described in clause (ii) of Act § 631(c)(3)(B).

The definition of "facilities" in Act § 631(b)(2)(C) does not apply in the case of the proposed refunding issues because an inducement resolution was not adopted before October 19, 1983. The apparent purpose of this definition is to provide that:

All property which is part of facilities described in an inducement resolution (or other comparable preliminary approval) adopted before October 19, 1983 pursuant to which the bonds are issued, is to be treated as under construction by October 19, 1983, where any part of those facilities are under construction before October 19, 1983. Moreover all such property is included under this transitional rule even though part of the facilities are transferred by the taxpayer prior to being placed in service and even though properties which are part of the facilities are placed in service before the completion of construction of other properties which are part of those facilities.

House Report at 1698-99; General Explanation at 954. Although the proposed refunding issues will not qualify for the benefits of this grouping rule, the fact that the construction of each of the "facilities" in question began before October 19, 1983 and the fact that the original use of each of such facilities commenced with the taxpayer obviate any need to rely on an inducement resolution for the refunding issues to provide a definition of "facilities" for purposes of the construction or binding obligation exception. The language of Act § 631(b)(2)(C), as well as a comparison of § 631(c)(3)(A) and § 631(a)(3) (which requires both an inducement resolution and construction or a binding obligation for purposes of another transition rule), indicates that the definition of "facilities" is not intended to impose the further requirement of a pre-October 19, 1983 inducement resolution, but merely to provide relief in cases where some but not all of the facilities identified in an inducement resolution satisfy the construction or binding obligation tests on the relevant date.

Finally, it must be noted that the applicability of the construction or binding obligation exception to refunding bonds in this manner is not inconsistent with the intent of the new restrictions. Congress was concerned about the proliferation of industrial development bonds, a source of increasing revenue loss and a factor contributing to inflated tax-exempt interest rates, and was particularly concerned about

the lack of an overall limitation per beneficiary for small issues. Code § 103(b)(15) itself recognizes that refunding issues do not increase the overall volume of tax-exempt bonds, but instead replace outstanding indebtedness. By reducing the interest cost on the existing issues, the proposed refunding issues will decrease the revenue loss and ease the upward pressure on tax-exempt interest rates with which Congress was concerned. The further Congressional concern that IDBs are an inefficient subsidy resulting in a misallocation of resources is inapplicable in these circumstances because the facilities have already been built, at a cost which would be reduced by the issuance of the refunding bonds. Given the concern evident in the construction or binding obligation not to disrupt economic choices which have already been made and which have been relied upon, it would be anomalous to thwart an attempt to ameliorate the perceived abuse and instead require it to persist unabated by adopting an interpretation of "obligations" which is inconsistent with the use of the term elsewhere in the Act and the Code.

Statement of Mark Barbash, Deputy Director, Ohio Department of Development

Mr. Chairman,

We appreciate this opportunity to present written testimony on an issue of prime importance to the State of Ohio's economic development/job creation efforts.

SUMMARY:

A proposed amendment to Section 103(o) of the Internal Revenue Code contained in H. R. 1800 (the "Technical Amendments Act of 1985") and the interpretation of that section by the staff of the Joint Committee on Taxation threatens to seriously impede the Ohio Economic Development Financing Program, unless it is "grandfathered" in that bill. This is a bipartisan program which Ohio has been operating for almost three years and by which the Department of Development makes low interest business loans to preserve and create jobs in Ohio. This program is financed with State bonds which are not industrial revenue bonds under Section 103(b) of the Internal Revenue Code. The Internal Revenue Service has so ruled, since the bonds are paid for entirely from Ohio's liquor profits. These are truly State bonds and are not a mere pass-through or conduit financing on behalf of private enterprise.

HISTORY OF THE PROGRAM:

The State of Ohio Economic Development Financing program (hereafter called the "166" program in reference to the chapter in the Ohio Revised code) provides financing for existing businesses in Ohio to expand their operations, create new jobs or retain existing jobs, and increase the state's tax base.

The program provides partial loans for fixed asset acquisition and renovation. Loans are made at a fixed rate of two-thirds (2/3) of prime. Eligible borrowers are Ohio corporations (and those moving into the state) engaged in manufacturing, distribution, research and development, and commerce.

The program has rigid criteria for investment:

- demonstrated job creation/retention
- a requirement for both conventional and equity financing for the project
- targeting of funds towards the distressed communities of the state
- a clear demonstration of the need for the state's limited funds.

In the past three years, the program has loaned out $130 million, leveraging a total of $650 million in investment, and impacted on the creation or retention of more than 25,000 jobs.

TAX EXEMPT STATUS:

The Ohio 166 program was established in 1982, pursuant to a formal ruling from the Internal Revenue Service that bond financing to be done in the program did not constitute "industrial development bonds" under Section 103(b) of the Code so that there would be no problem with tax exemption of the bonds. The Ohio Supreme Court further ruled that such bonds properly commit and apply the liquor profits of the State to the public purpose declared by the people of Ohio in Art. 8, Sec. 14, Ohio Constitution. The program was authorized by near unanimous and bipartisan adoption of state legislation in 1980 and has been operated successfully under successive gubernatorial administrations of both parties. (See Exhibit B - State Code)

The loans are funded and the guarantees are backed by the ability of Ohio to issue bonds which are secured by and paid solely from the profits the state earns from its operation of the wholesale and retail liquor enterprise pursuant to the 21st Amendment of the U. S. Constitution and the laws of the State of Ohio. Principal and interest on those bonds is paid solely from these state liquor profits. The repayments of loans go into a revolving fund from which new and similar loans are made. None of the moneys from such loan repayments is in any way pledged to or is available for paying the principal or interest on the bonds (and, in fact, the interest on the loan is so low that loan repayments would not be sufficient to pay the bonds). It was for that reason that the Internal Revenue Service determined by formal ruling that these bonds are not "industrial development bonds" within the meaning of IRC Section 103(b). They do not meet the "security interest test" for industrial development bonds. (See Exhibit C)

The purposes for the unusual structure are several:

1) The Ohio Constitution prohibits use of tax funds for business loans. Thus, the liquor profits are used to support the bond repayments, rather than repayment from the borrowers.
2) Borrower repayments go back into the fund for relending to other Ohio businesses.
3) The cost to the state for subsidizing the bonds is reduced through their tax exempt status.
4) The escrowing of funds from the bond sale allows much greater flexibility in the state's ability to fund approved projects expeditiously.
5) The earnings on the escrowed funds are utilized to support the administrative costs of running the program, thus reducing the need for appropriated taxpayer funds.
6) Costs to borrowers for loan closings are kept lower.

COMPARISON WITH IDB's:

The 166 program is generally much more restrictive than IDB's in the areas that are most controversial. It does not finance retail businesses or restaurants. Job creation criteria is strict. The funds are targeted to distressed communities. State 166 loans finance only a part of a project.

The flexibility which comes from the non-IDB status is in the disbursal and "use of funds" areas. Because our funds are escrowed, we can disburse funds expeditiously. Legal fees are lower. We can finance smaller projects which are inefficient for IDB purposes.

Probably most importantly, the flexibility allows us to actively participate in the reopening of factories which are closed down by the "conglomerate" owners. This happens usually through a management or employee-buyout. The restrictions on use of IDB funds for land and building acquistion (without any significant rehabilitation) would make these projects generally unfinanceable.

These kinds of projects have the greatest impact of all our loans: they create and retain a large number of jobs, the benefits to the communities are great (since the factories are usually the largest employers), and they therefore have the greatest community support.

THE "CONSUMER LOAN BONDS" PROVISION OF THE DEFICIT REDUCTION ACT OF 1984:

Section 626 of the Deficit Reduction Act of 1984 enacted a new subsection (o) of Section 103 I.R.C. to provide that the interest on "Consumer Loan Bonds" would not be exempt from Federal taxation under Section 103(a) of the Code. The obvious objective was to deal with the potential issuance of tax-exempt bonds to provide funds to make personal loans for the purchase of consumer products such as automobiles and household appliances. There had been talk of the origination of such programs and the provision was intended, we believe, to forestall such efforts. We believe that Congress intended to address personal loans and not job intensive business loans by the "Consumer Loan Bond" provision. The report to the Senate Committee on Finance explained the need for the provision as follows:

> "Presently, tax-exempt bonds may be issued to finance personal loans to individuals for non-business purposes, including the financing of student loans. Because the proceeds of such loans generally are not used in the conduct of a trade or business, these bonds are not subject to restrictions applicable to industrial development bonds." (P.705)
>
> "The committee is concerned about the growing use of tax-exempt bonds to finance loans for personal expenses of higher education . . . and the possible use of tax-exempt bonds to finance other personal loans." (P.706) (emphasis added)
>
> ". . . With respect to bonds for other types of personal loans, the committee believes it is appropriate to adopt a general rule denying tax-exemption." (P.707) emphasis added)

Likewise, in the Conference report, the reason for the Consumer Loan Bond provision was explained as follows:

> "Present law does not provide limitations on the use of proceeds of tax-exempt bonds for private purposes except in the case of bonds where the proceeds are used in the taxable trades or businesses (i.e., industrial development bonds) or bonds where the proceeds are used to provide financing of owner-occupied housing (i.e., mortgage subsidy bonds)." (P.1213)

Not only did the name "Consumer Loan Bonds" convey the intention of Congress to deal with personal loans rather than business loans, but every reference in the Committee Reports supports that intention. Furthermore, we believe that Congress intended to deal only with those bonds which were secured by or paid from the repayment of those loans (i.e., conduit or pass-through bonds, where a security interest is met), and not to deal with bonds that are secured by and paid from unrelated state revenues which were formerly used for the general purposes of the State.

THE TECHNICAL CORRECTIONS ACT OF 1985 AMENDMENT OF SEC. 103(o):

Section 166 of the Technical Amendments Act of 1985 (H.B. 1800), would change the references in the headings and substance of Section 103(o) IRS from "consumer loan bond" to "private loan bond". The object of this rather simple change appears to be to support a broad interpretation of Section 103(o).

Thus, the pamphlet prepared by the staff of the Joint Committee on Taxation and submitted to Congress describes this amendment in H.R. 1800 as follows (the "Act" referred to is the Tax Reform Act of 1984):

"Consumer loan bonds

The bill clarifies the scope of the Act's consumer loan bond restriction. The bill retitles consumer loan bonds "private loan bonds" to reflect the fact that all bonds issued to finance loans to nonexempt persons are subject to this restriction unless a specific exception is provided (e.g., IDBs, mortgage subsidy bonds, and qualified student loan bonds).

This restriction applies whether bonds are used to finance loans for businesses or to finance personal loans. For example, an issue may be an issue of private loan bonds if 5 percent or more, but less than 25 percent of the proceeds are used to provide financing that would be considered IDB-financing, but for the fact that under Treasury Department regulations, bonds are not treated as IDBs if less than 25 percent of the proceeds is used for a purpose described in section 103(b). Similarly, an obligation that would be an IDB except for the fact that the security interest test of section 103(b)(2)(B) is not satisfied is a private loan bond." Joint Committee on Taxation, Description of the Technical Corrections Act of 1985 (H.R. 1800 and S. 814), (JCS-7-85), Apr 14, 1985.

H.R. 1800 seeks to codify a very broad definition of Section 103(o). This clearly puts the Ohio economic development program under an ominous cloud, and, in effect, repeals the favorable formal ruling previously obtained from IRS.

IMPACT ON THE 166 PROGRAM:

To retain the tax exempt status of future Economic Development Revenue Bond issuances, the Department would have to totally restructure the operation of the program.

There are major differences between 166 loans and those IDB's which historically may have abused their tax exempt nature.

Nevertheless, the changes envisioned in H.R. 1800 would have a serious impact on the 166 program.

The impact of this change would be significant:

1) All applicants would have to meet a variety of IRB restrictions unrelated to credit or collateral. For example, a project financed with tax exempt financing can spend no more than 25% of proceeds for acquiring existing buildings. If there is acquisition, at least 15% of proceeds would have to go for rehabilitation.

2) Legal fees would likely increase for the borrower, inasmuch as they would have to cover additional costs beyond the closing of their particular loan.

3) The timing of disbursals would be critical. Umbrella bonds would likely be sold based not upon approval, but on loan closing. Should closing on one project in an umbrella bond issuance be delayed, others in that issuance would have to wait for an indeterminate period of time.

   This would cause severe paperwork for all borrowers, and delay the job creation envisioned by the program.

4) At a time when we are trying to make the program more accessible to Ohio business, this could have exactly the opposite impact.

ANALYSIS OF PAST PROJECTS:

We have evaluated half of the projects financed over the last 2 years by the 166 program. Our hypothetical question: "If we had to apply IDB regulations to our historical borrowers, could we have financed their projects?"

Based on this analysis, at least 40% of the projects financed to date would not be feasible under the new restrictions. This would involve at least $31 million in State investment, $140 million in total project investment, and more than 5,000 jobs.

These projects would be unfinanceable not because of the historic objections to IDB's. Rather, many of the projects are those which involve the reopening of closed industrial facilities or the purchase of businesses which would otherwise have closed.

REQUESTED RELIEF:

Without arguing the merits or lack thereof of the purposes of Section 103(o) of the Code as proposed to be clarified and applied under H.R. 1800, we believe that Congress would support the Ohio program which is declared by its people under its Constitution to support a public purpose of creating and preserving jobs and which is paid for by Ohio's liquor profits which formerly went to its general revenue fund.

Further, since the Ohio 166 program is the only one in the nation so structured, this program ought to be safeguarded by an appropriate grandfather provision. A proposal follows. It is urged that it, or one substantially similar, be included in H.R. 1800.

PROPOSED

AMENDMENT FOR
TECHNICAL CORRECTIONS ACT OF 1985
(H.R. 1800; S. 814)

Section 166 (Amendments Related to Section 626 of the Act) is amended by adding at the end thereof the following new subsection:

(c) Subsection (b) of section 626 of the Tax Reform Act of 1984 (relating to effective date and exceptions from consumer loan bond provisions) is amended by adding at the end thereof the following new paragraph:

"(7) Exception for certain state subsidized program. -- The amendments made by this section shall not apply to any obligations issued by a state government, payable from state liquor profits or other non-tax revenues, pursuant to a state program established by state legislation, effective May 2, 1980, to authorize low interest loans and guarantees of loans for land and property to a character subject to the allowance for depreciation to create or preserve jobs in industry, commerce, distribution, or research."

INDEX OF EXHIBITS

1) Exhibit A - List of projects financed by the Ohio 166 Program since January, 1983.

2) Exhibit B - Ohio Revised Code Chapter 166. Legislation which enacts Ohio program.

3) Exhibit C - Private Letter Ruling which determined the tax-exempt (non-IDB) status of the 166 Program.

4) Exhibit D - List of projects which could not be financed if the proposed IDB regulations were in effect for the past two years. Based on 50% sampling.

EXHIBIT A

LIST OF PROJECTS FINANCED BY THE OHIO 166 PROGRAM SINCE JANUARY 1983

DEVELOPMENT FINANCING ADVISORY BOARD
Transactions Through April 26, 1985

Company Project City/County Type of Business	Number of Jobs Retained	Number of Jobs Created (in 3 yrs)	Significant Dates DFAB	Significant Dates Controlling Board	Significant Dates Inducement	Significant Dates Closing	Form of State Assistance Direct Loan	Form of State Assistance Loan Guarantee	Allowable Costs	Percent of Participation
1. National Biological Corp.* Twinsburg/Summit Mfg. light treatment equipment		40	8-31-83	9-26-83	10- 7-83	12-21-83	$ 101,000		$ 410,000	25%
2. Adex Inc. Woodland/Hamilton Mfg. exhibits	30	43	8-31-83	9-12-83	9-29-83	7-17-84	489,200		1,233,000	40%
3. Ohio Pure Foods* Akron/Summit Mfg. fruit juices		33	8-31-83	9-26-83	10-11-83	4-10-84	84,600		282,000	30%
4. E.W. Buschman Co. Union Twp/Butler Mfg. conveyor equipment	260	77 (5 yrs)	8-31-83	9-12-83	10- 3-83		1,000,000		7,000,000	14%
5. Manchester Mfg. Manchester/Adams Mfg. slacks & shorts		125 (6 mos)	8-31-83	9-26-83	10-20-83	5- 1-84	175,000		252,000	69%
6. North American Plastics Galion/Crawford Mfg. bathroom accessories		53 (2 yrs)	8-31-83	9-12-83	10- 1-83	12- 6-83		$ 562,500 (75% of $750,000)	963,000	58%
7. LXD Inc. Beachwood/Cuyahoga Mfg. liquid crystal displays	98	82	9-27-83	10-11-83	10-17-83	12-13-83	795,000		1,670,000	48%
8. Pride Cast Metals Cincinnati/Hamilton Mfg. metal castings	30	70 (4 yrs)	9-27-83	10-11-83	10-24-83	1- 9-84	417,000		832,000	50%
9. GBKS (Gradall) New Philadelphia/Tuscarawas Mfg. excavators & material handlers	423	100	9-27-83	10-11-83	10-28-83	10-28-83	2,160,000		9,230,000	23%

Company Project City/County Type of Business	Number of Jobs Retained	 Created (in 3 yrs)	Significant Dates DFAB	 Controlling Board	 Inducement	 Closing	Form of State Assistance Direct Loan	 Loan Guarantee	Allowable Costs	Percent of Participation
10. Goodall Properties (Foxx) Cincinnati/Hamilton Office bldg. renovation		124	2-28-84	3-19-84	5-16-84	8/28/84	$ 850,000		$ 2,275,000	37%
11. Great Northern Wood Preserving Lodi/Medina Wood treating		22	11-29-83	12-19-83	12-20-83	12-21-84	225,000		749,844	30%
12. Arrow International (Clinton Road Project) Brooklyn/Cuyahoga Specialty printing, sweepstakes		179	11-29-83	12- 5-83	12- 8-83	1-13-84	1,000,000		2,850,000	35%
13. American Research Products Warrensville Hts/Cuyahoga Mfg. chemical reagents		115	11-29-83	12-19-83			280,000		560,000	50%
14. Schneller Inc. Kent/Portage Mfg. aircraft interiors	70	13	11-29-83	12- 5-83	12- 5-83	12-15-83	1,100,000		6,250,000	18%
15. MCE Incorporated Waynesville/Warren Mfg. of cast acrylic sheet		40	12-19-83	1- 9-84	1-23-84	12-31-84	150,000		525,000	29%
16. American Fan Fairfield/Butler Mfg. industrial fans/blowers		40	12-19-83	1- 9-84	3- 5-84	7-12-84	604,748		1,209,996	50%
17. Burke Marketing Services (800 Broadway) Cincinnati/Hamilton Marketing research	1,027	370	12-19-83	1- 9-84	1-11-84		1,750,000		12,240,000	14%
18. Dietrich Industries, Inc. Warren/Trumbull Process Steel to Specifications		120	1-31-84	2-22-84	3-27-84	6- 5-84	$ 1,000,000		$ 4,016,880	25%

Company Project City/County Type of Business	Number of Jobs Retained	 Created (in 3 yrs)	Significant Dates DFAB	 Controlling Board	 Inducement	 Closing	Form of State Assistance Direct Loan	 Loan Guarantee	 Allowable Costs	 Percent of Participation
19. Kraft Maid Cabinetry Middlefield/Geauga Mfg. Kitchen/Bath Cabinets		204	1-31-84	2-22-84	2-23-84	9-17-84	1,570,000		3,161,000	50%
20. R&R Properties W. Unity/Williams Building Space for Industries		---	1-31-84	2-22-84	2-23-84	4-13-84	450,000		950,000	48%
21. Carborundum Grinding Wheel Company Falls Twp./Hocking Mfg. Resinoid Grinding Wheels		100	1-31-84	2- 6-84	2-10-84	3- 2-84	755,000		1,900,000	40%
22. Advanced Technology Corp./ Advanced Med. Systems Geneva/Ashtabula Mfg. Headlights/Gamma Units/Badges etc.		117	2-28-84	3-19-84	5- 1-84		511,000		1,622,000	32%
23. Erieview Metal Treating Co. Cleveland/Cuyahoga Electroplating		47	2-28-84	3-19-84	4-13-84		750,000		2,300,000	33%
24. Cincinnati Convention Ctr. Cincinnati/Hamilton Conventions		333	2-28-84	3-19-84	4- 2-84	6-22-84	2,500,000		52,000,000	5%
25. Nordic Capital Corporation Sebring/Mahoning Mfg. China	380	190	2-28-84	3- 5-84	3- 5-84	3-29-84	1,000,000		3,000,000	50%
26. Superior Glass Fibers Inc. Breman/Fairfield Mfg. Filter Media/ Fiberglass Mats	100	80	4-24-84	4-30-84	5- 3-84	5-11-84	$ 600,000		$ 2,700,000	22%

Company Project City/County Type of Business	Number of Jobs Retained	Created (in 3 yrs)	Significant Dates DFAB	Controlling Board	Inducement	Closing	Form of State Assistance Direct Loan	Loan Guarentee	Allowable Costs	Percent of Participation
27. Greenfield Foods Inc. Greenfield/Highland Processing Hogs into Pork		300	4-24-84	5-14-84	8-13-84	9-24-84	2,500,000		6,000,000	42%
28. Miami Systems Corp. Blue Ash/Hamilton Designing and Printing Business Forms	91	68	4-24-84	5-14-84	5-22-84	9- 4-84	700,000		1,991,000	35.2%
29. B&D Plastics (Arrow Molded Plastics) Byesville/Guernsey Mfg. Molded Plastic Parts	34%	164	4-24-84	5-14-84	6-27-84	12-14-84	1,000,000		2,700,000	37%
30. Jeno's Jackson & Wellston/ Jackson County Food Mfg.	300	910	5- 1-84	5-14-84	10-15-84		7,500,000		11,328,500	67%
31. Multicon Inc. (Richard P. Bell) Newtown/Hamilton Robots, Machine Vision, Micro-computers	8	40	5-29-84	6-11-84	8- 2-84		330,000		660,000	50%
32. Super Foods Service, Inc. Blue Ash/Hamilton Wholesale Food and Non-Food Products to Retail Food Services		65	5-29-84	6-11-84	7- 3-84		1,700,000		7,090,000	24%
33. Ronneburg Brewery Youngstown/Mahoning Brewer of Beer		200	5-29-84	6-11-84			$ 2,500,000		$20,000,000	12.5%

Company Project City/County Type of Business	Number of Jobs Retained	Number of Jobs Created (in 3 yrs)	Significant Dates DFAB	Significant Dates Controlling Board	Significant Dates Inducement	Significant Dates Closing	Form of State Assistance Direct Loan	Form of State Assistance Loan Guarantee	Allowable Costs	Percent of Participation
34. Bendtech Glass, Inc.* Perrysburg Twp./Wood Mfg. of Bent Glass		40	5-29-84	6-11-84	6-20-84	9- 6-84	190,000		425,000	44%
35. Comp-U-Card Int'l, Inc. Columbus/Franklin Customer Access to Product Information Service		108	5-29-84	6-11-84	7- 5-84	12-28-84	300,000		600,000	50%
36. Brevin Enterprises, Inc.* Akron/Summit Mfg. Wheel Parts for Defense Industry		48	5-29-84	6-11-84	7-12-84		194,000		485,000	40%
37. R L Industries Inc. Union/Butler Mfg. Plastic Products	60	90	5-29-84	6-11-84	6-28-84		690,000		1,470,000	47%
38. Roxane Laboratories Columbus/Franklin Mfg. Pharmaceuticals	267	77	5-29-84	8-13-84	10-11-84		4,000,000		26,000,000	15%
39. Thermatex Corp. Newton Falls/Trumbull Mfg. Insulating Products	63	83	6-26-84	7- 9-84	7-24-84	11-28-84	400,000		1,610,000	25%
40. Vinton County Dry Kiln Inc. Dundas/Vinton Lumber Drying	10	46	6-26-84	7- 9-84	7-30-84	2-19-85	600,000		1,750,000	34%
41. Rainbow Machined Products Co. Springboro/Warren Mfg. of Machined Components	65	70	6-26-84	7- 9-84	11- 7-84		350,000		1,060,200	33%
42. CSC Inc. New Lexington/Perry Mfg. Roof Tiles	100	250	6-26-84	7- 9-84			$ 700,000		$ 5,000,000	14%

Company Project City/County Type of Business	Number of Jobs Retained	Number of Jobs Created (in 3 yrs)	Significant Dates DFAB	Significant Dates Controlling Board	Significant Dates Inducement	Significant Dates Closing	Form of State Assistance Direct Loan	Form of State Assistance Loan Guarantee	Allowable Costs	Percent of Participation
43. Blendepac Corp. Cincinnati/Hamilton Medical/Dietetic Foods	165	150	6-26-84	7- 9-84	8-20-84		3,300,000		5,875,000	56%
44. Hamilton Allied Corp. Harrison/Hamilton Iron Castings	230	30	8-28-84	9-10-84	9-13-84	10- 5-84	1,750,000		3,500,000	50%
45. Hayes-Albion Tiffin/Seneca Mfg. Metal Castings and Fabricated Products		70	8-28-84	9-10-84	9-26-84		800,000		2,100,000	38%
46. Defiance Precision Prod. Defiance/Defiance Mfg. Cam Follower Rollers	200	139	8-28-84	9-10-84	11- 6-84		2,000,000		10,225,000	20%
47. Enginetics Corporation Huber Hts./Montgomery Metal Fabricating	97	100	8-28-84	9-10-84	9-21-84		569,250		1,265,000	45%
48. Newmarket Hotel Ltd. Canton/Stark Hotel		356	8-28-84	9-10-84	9-27-84	10-25-84	3,200,000		14,000,000	23%
49. Armco Inc. Middletown/Butler Electrolytic Steel Plating		C A N C E L L E D								
50. The United States Can Company, Inc. Hubbard/Trumbull Mfg. of Cans	50	50	9-25-84	10- 9-84	1- 4-85		450,000		2,000,000	23%
51. KBK Company Perrysburg/Wood Marketing Support Services	53	35	9-25-84	10- 9-84	1-31-85		$ 700,000		$ 4,107,000	33%

Company Project City/County Type of Business	Number of Jobs Retained	Created (in 3 yrs)	Significant Dates DFAB	Controlling Board	Inducement	Closing	Form of State Assistance Direct Loan	Loan Guarantee	Allowable Costs	Percent of Participation
52. Toledo/Lucas County Convention and Visitors Bureau Inc. Toledo/Lucas Accomodation for Meetings/ Trade Shows		859	9-25-84	10- 9-84	10-30-84		2,500,000		17,717,000	14%
53. Duramed Research Assoc. Duramed Pharmaceuticals Cincinnati/Hamilton Mfg. - Pharmaceuticals		220	10-30-84	11-19-84	12- 7-84	4-25-85	2,200,000		7,455,000	30%
54. N. American Philips Consumer Electronics Ottawa/Putnam Mfg. of Color TV Picture Tubes	1,640	297	10-30-84	11-19-84	12- 4-84		2,500,000		6,190,000	40%
55. Ashland Railway Inc. Mansfield/Ashland Rail Transportation of Manufactured Goods	700	4	11-27-84	1-14-85				380,000 (50% of $760,000)	960,000	40%
56. Adventure Investments Delaware/Delaware Mfg. of Heating/Cooling Equipment	31	27	12-18-84	1- 8-85	2- 1-85	2-28-85	245,000		600,000	41%
57. Poly Foam Int'l. Inc. Fremont/Sandusky Mfg. of Mobile Home Accessories	58	56	12-18-84	1- 8-85	1-25-85		500,000		1,714,000	29%
58. Saramar Aluminum Co. Warren/Trumbull Extruder of Aluminum Parts	--	100	12-18-84				$ 400,000		$ 900,000	44%

Company Project City/County Type of Business	Number of Jobs Retained	Number of Jobs Created (in 3 yrs)	Significant Dates DFAE	Significant Dates Controlling Board	Significant Dates Inducement	Significant Dates Closing	Form of State Assistance Direct Loan	Form of State Assistance Loan Guarantee	Allowable Costs	Percent of Participation
59. Omega Hydraulics, Inc. Springfield/Clark Mfg./Repair Hydraulic Cylinders	—	72	12-18-84	2-11-85				356,250 (75% of $475,000)	575,000	62%
60. Hall Machine Co., Inc. Alliance/Stark Repair/Mfg./Modification of Tools & Heavy Equipment	—	40	12-18-84					534,630 (71% of $753,200)	1,034,000	52%
61. Ironton Iron, Inc. Ironton/Lawrence Mfg. of Ferrous Castings	—	560	1-17-85				1,000,000		4,690,000	21%
62. National Feed Screw & Machining Industries, Inc. Massilon/Stark Mfg. of Die Component Parts	14	108	1-29-85	2-11-85	3-13-85	4-15-85	1,600,000		3,300,000	48%
63. Coca Cola Bottling Corp. Corp. of Cincinnati Cincinnati/Hamilton Mfg./Distributor of Soft Drinks	500	55	1-29-85	2-11-85			2,250,000		12,700,000	18%
64. Therapeutic Technologies Alpha/Greene Mfg./Distributor Bio Medical Rehab. Products	24	294	1-29-85	3-11-85	3-11-85	3-19-85	250,000		2,000,000	13%
65. Economy Barge Repair Inc. (L. Dale Manne) Fayette/Bette Twps./Lawrence Barge Cleaning, Dry Dock/ Construction	—	80	1-29-85	2-11-85			320,000		1,169,800	27%

Company Project City/County Type of Business	Number of Jobs Retained	 Created (in 3 yrs)	Significant Dates DFAB	 Controlling Board	 Inducement	 Closing	Form of State Assistance Direct Loan	 Loan Guarantee	Allowable Costs	Percent of Participation
66. B.B.F. (Bedinghaus Business* Business Forms) Sharonville/Hamilton Mfg. of Business Forms	208	20	2-26-85	3-11-85	3-12-85		$ 1,200,000		$ 3,556,000	34%
67. Tricon (Amko Plastics) Blue Ash/Hamilton Mfg. of Polyethylene Bags	30	154	2-26-85	3-11-85			1,000,000		2,500,000	40%
68. Merryweather Foam Inc. Barberton/Summit Mfg. of Foam Rubber Products	98	—	3-14-85	3-25-85	4-15-85		500,000		2,210,000	23%
69. Amanda Bent Bolt Co. Logan/Hocking Mfg. Formed Rod Products	—	75	3-14-85				396,000		1,160,000	34%
70. Sandusky Bay Development Co. Sandusky/Erie Operation of a Marina	—	75	3-14-85					900,000 (75% of $1,200,000)	4,424,937	20%
71. Hyden Investments Arcanum/Drake Automotive Weather Stripping		230	4-11-85	4-22-85			500,000		2,112,975	24%
72. May Dept. Stores Co. Cleveland/Cuyahoga Retail Sales	2,969		4-11-85	4-22-85			1,000,000		4,417,015	23%
73. Valley Foods Inc. Youngstown/Mahoning Institutional Food Services	52	50	4-11-85	4-22-85			725,000		2,875,000	25%
74. Regal Transportation Inc. Weathersfield Twsp./Trumbull	130	6	4-11-85	4-22-85			150,000		220,000	68%
TOTAL	10,979	9,588					$76,476,798	$2,733,380	$396,904,147	20%

* 122 Projects (All others 166)

Lry8f45

EXHIBIT B

OHIO REVISED CODE CHAPTER 166

LEGISLATION WHICH ENACTS OHIO PROGRAM

CHAPTER 166: ECONOMIC DEVELOPMENT PROGRAM

Section

166.01 [Definitions.]
166.02 [Declaration of public policy to assist eligible projects in local economic needs areas; powers of director; prevailing wage to be paid.]

[FACILITIES ESTABLISHMENT FUND]

166.03 [Facilities establishment fund created.]
166.04 [Director to determine whether assistance will conform to chapter; notice of application for assistance.]
166.05 [Criteria for selecting projects to be assisted; nature, amount and terms; determination that benefits exceed cost; development advisory committee created.]
166.06 [Director may enter into contracts to guarantee repayment of loans from loan guarantee fund.]
166.07 [Loans from the facilities establishment fund.]
166.08 [Issuance of obligations; refunding; anticipation notes; pledge of receipts; economic development bond service fund created; tax exemption.]
166.09 [Disposition of loan repayments, recovery on guarantees and other proceeds.]
166.10 [Relationship to other laws and agency powers; severability of provisions.]
166.11 [Limitations on aggregate amounts of obligations and guarantees; provisions for small businesses.]

§ 166.01 [Definitions.]

As used in Chapter 166. of the Revised Code:

(A) "Allowable costs" means all or part of the costs of project facilities, including costs of acquiring, constructing, reconstructing, rehabilitating, renovating, enlarging, improving, equipping, or furnishing project facilities, site clearance and preparation, supplementing and relocating public capital improvements or utility facilities, designs, plans, specifications, surveys, studies, and estimates of costs, expenses necessary or incident to determining the feasibility or practicability of assisting an eligible project or providing project facilities, architectural, engineering, and legal services fees and expenses, and such other expenses as may be necessary or incidental to the establishment or development of an eligible project, and reimbursement of moneys advanced or applied by any governmental agency or other person for allowable costs.

(B) "Eligible project" means project facilities to be acquired, established, expanded, remodeled, rehabilitated, or modernized for industry, commerce, distribution, or research, or any combination thereof, the operation of which, alone or in conjunction with other facilities, will create new jobs or preserve existing jobs and employment opportunities and improve the economic welfare of the people of the state. For purposes of this division, "new jobs" does not include existing jobs transferred from another facility within the state, and "existing jobs" includes only those existing jobs with work places within the municipal corporation or unincorporated area of the county in which the eligible project is located.

(C) "Financial assistance" means inducements under division (B) of section 166.02 of the Revised Code, loan guarantees under section 166.06 of the Revised Code, and direct loans under section 166.07 of the Revised Code.

(D) "Governmental action" means any action by a governmental agency relating to the establishment, development, or operation of an eligible project and project facilities that the governmental agency acting has authority to take or provide for the purpose under law, including, but not limited to, actions relating to contracts and agreements, zoning, building, permits, acquisition and disposition of property, public capital improvements, utility and transportation service, taxation, employee recruitment and training, and liaison and coordination with and among governmental agencies.

(E) "Governmental agency" means the state and any state department, division, commission, institution or authority; a municipal corporation, county, or township, and any agency thereof, and any other political subdivision or public corporation or the United States or any agency thereof; any agency, commission, or authority established pursuant to an interstate compact or agreement; and any combination of the foregoing.

(F) "Person" means any individual, firm, partnership, association, corporation, or governmental agency, and any combination thereof.

(G) "Project facilities" means buildings, structures, and other improvements, and equipment and other property, excluding small tools, supplies, and inventory, and any one, part of or combination of the foregoing, comprising all or part of, or serving or being incidental to, an eligible project, including, but not limited to, public capital improvements.

(H) "Property" means real and personal property and interests therein.

(I) "Public capital improvements" means capital improvements or facilities that any governmental agency has authority to acquire, pay the costs of, own, maintain, or operate, or to contract with other persons to have the same done, including, but not limited to, highways, roads, streets, water and sewer facilities, railroad and other transportation facilities, and air and water pollution control and solid waste disposal facilities.

HISTORY: 128 v S 313 (Eff 5-2-60); 140 v S 227. Eff 7-14-83.

The provisions of § 6 of SB 227 (140 v —) read as follows:

SECTION 6. Section 166.01 of the Revised Code as amended by Section 1 of this act does not affect the prior operation of the definition of "eligible project" in division (B) of that section insofar as it applies to any application for financial assistance that was submitted under Chapter 166. of the Revised Code before the effective date of this

act. However, if an application for financial assistance was submitted under Chapter 166. of the Revised Code before the effective date of this act and was denied or is pending subject to denial solely because the project facilities are or were not to be operated by any person who, prior to January 1, 1980, or for any period of five years after January 1, 1980, owned, rented, or leased and operated property in Ohio for use in industry, distribution, commerce, or research, the application may be resubmitted on or after the effective date of this act or, if pending on the effective date of this act, may be processed and approved the same as if it had been submitted on that date.

Cross-References to Related Sections

Division of economic development financing; established, RC §§ 122.84, 122.85.

Comparative Legislation

Definitions:
CA—Gov't Code § 15310
FL—Stat Ann § 288.105
IL—Ann Stat ch 48 § 901
IN—Code § 4-26-3-14
KY—Rev Stat Ann § 152.750
MI—Comp Laws Ann § 125.1906
NY—Agric & MLaw § 269
PA—CSA tit 73 § 371

Research Aids

Economic development program:
O-Jur2d: Industrial, economic, and community development § 5

CASE NOTES AND OAG

1. (1961) Revised Code Chapter 166 contemplates the use of moneys in the Liquor Control Fund prior to a determination of "excess" under RC § 4301.12, and thus does not violate Art VIII, § 13 of the Ohio Constitution: State ex rel. Duerk v. Donahey, 67 OS2d 216, 21 OO3d 135, 423 NE2d 429.

§ 166.02 [Declaration of public policy to assist eligible projects in local economic needs areas; powers of director; prevailing wage to be paid.]

(A) The general assembly finds that many local areas throughout the state are experiencing economic stagnation or decline, and that the economic development program provided for by Chapter 166. of the Revised Code will constitute a deserved, necessary reinvestment by the state in those areas, materially contribute to their economic revitalization, and result in improving the economic welfare of all the people of the state. Accordingly, it is declared to be the public policy of the state, through the operations under Chapter 166. of the Revised Code and other applicable laws adopted pursuant to Section 13 of Article VIII, Ohio Constitution, and other authority vested in the general assembly, to assist in and facilitate the establishment or development of eligible projects or assist and cooperate with any governmental agency in achieving such purpose.

(B) In furtherance of such public policy and to implement such purpose, the director of development may:

(1) With the approval of the governor, and after consultation with appropriate governmental agencies, enter into agreements with persons engaged in industry, commerce, distribution, or research and with governmental agencies to induce such persons to acquire, construct, reconstruct, rehabilitate, renovate, enlarge, improve, equip, or furnish, or otherwise develop, eligible projects and make provision therein for project facilities and governmental actions, as authorized by this chapter and other applicable laws, subject to any required actions by the general assembly or the controlling board and subject to applicable local government laws and regulations;

(2) Provide for the guarantees and loans as provided for in sections 166.06 and 166.07 of the Revised Code;

(3) Subject to release of such moneys by the controlling board, contract for labor and materials needed for, or contract with others, including governmental agencies, to provide, project facilities the allowable costs of which are to be paid for or reimbursed from moneys in the facilities establishment fund, and contract for the operation of such project facilities;

(4) Subject to release thereof by the controlling board, from moneys in the facilities establishment fund acquire or contract to acquire by gift, exchange, or purchase, including the obtaining and exercise of purchase options, property, and convey or otherwise dispose of, or provide for the conveyance or disposition of, property so acquired or contracted to be acquired by sale, exchange, lease, lease purchase, conditional or installment sale, transfer, or other disposition, including the grant of an option to purchase, to any governmental agency or to any other person without necessity for competitive bidding and upon such terms and conditions and manner of consideration pursuant to and as the director determines to be appropriate to satisfy the objectives of Chapter 166. of the Revised Code;

(5) Retain the services of or employ financial consultants, appraisers, consulting engineers, superintendents, managers, construction and accounting experts, attorneys, and employees, agents, and independent contractors as are necessary in his judgment and fix the compensation for their services;

(6) Receive and accept from any person grants, gifts, and contributions of money, property, labor, and other things of value, to be held, used and applied only for the purpose for which such grants, gifts, and contributions are made;

(7) Enter into appropriate arrangements and agreements with any governmental agency for the taking or provision by that governmental agency of any governmental action;

(8) Do all other acts and enter into contracts and execute all instruments necessary or appropriate to

carry out the provisions of Chapter 166. of the Revised Code;

(9) Adopt rules to implement any of the provisions of Chapter 166. of the Revised Code applicable to the director.

(C) The determinations by the director that facilities constitute eligible projects, that facilities are project facilities, that costs of such facilities are allowable costs, and all other determinations relevant thereto or to an action taken or agreement entered into shall be conclusive for purposes of the validity and enforceability of rights of parties arising from actions taken and agreements entered into under this chapter.

(D) Except as otherwise prescribed in Chapter 166. of the Revised Code, all expenses and obligations incurred by the director in carrying out his powers and in exercising his duties under Chapter 166. of the Revised Code, shall be payable solely from, as appropriate, moneys in the facilities establishment fund, the loan guarantee fund, or moneys appropriated for such purpose by the general assembly. Chapter 166. of the Revised Code does not authorize the director or the issuing authority under section 166.08 of the Revised Code to incur bonded indebtedness of the state or any political subdivision thereof, or to obligate or pledge moneys raised by taxation for the payment of any bonds or notes issued or guarantees made pursuant to Chapter 166. of the Revised Code.

(E) No financial assistance for project facilities shall be provided under this chapter unless the provisions of the agreement providing for such assistance specify that all wages paid to laborers and mechanics employed on such project facilities for which the assistance is granted shall be paid at the prevailing rates of wages of laborers and mechanics for the class of work called for by such project facilities, which wages shall be determined in accordance with the requirements of Chapter 4115. of the Revised Code for determination of prevailing wage rates, provided that the requirements of this division do not apply where the federal government or any of its agencies provides financing assistance as to all or any part of the funds used in connection with such project facilities and prescribes predetermined minimum wages to be paid to such laborers and mechanics; and provided further that should a nonpublic user beneficiary of the eligible project undertake, as part of the eligible project, construction to be performed by its regular bargaining unit employees who are covered under a collective bargaining agreement which was in existence prior to the date of the document authorizing such assistance then, in that event, the rate of pay provided under the collective bargaining agreement may be paid to such employees.

(F) Any governmental agency may enter into an agreement with the director, any other governmental agency, or a person to be assisted under this chapter, to take or provide for the purposes of this chapter any governmental action it is authorized to take or provide, and to undertake on behalf and at the request of the director any action which the director is authorized to undertake pursuant to divisions (B)(3), (4), and (5) of this section. Governmental agencies of the state shall cooperate with and provide assistance to the director of development and the controlling board in the exercise of their respective functions under this chapter.

HISTORY: 138 v S 313 (Eff 5-2-80); 139 v H 536 (Eff 8-12-82); 140 v S 227. Eff 7-14-83.

Cross-References to Related Sections

Department of industrial relations to determine wages, RC § 4115.03.2.

Research Aids

Economic development program:
O-Jur2d: Industrial, economic and community development § 5
Am-Jur2d: Pub Wks §§ 1—2

ALR

Validity of statute, ordinance, or charter provision requiring that workmen on public works be paid the prevailing or current rate of wages. 18 ALR3d 944.

[FACILITIES ESTABLISHMENT FUND]

§ 166.03 [Facilities establishment fund created.]

(A) There is hereby created the "facilities establishment fund" within the state treasury, consisting of proceeds from the issuance of obligations as specified under section 166.08 of the Revised Code; the moneys received by the state from the sources specified in section 166.09 of the Revised Code; service charges imposed under sections 166.06 and 166.07 of the Revised Code; any grants, gifts, or contributions of moneys received by the director of development to be used for loans made under section 166.07 of the Revised Code or for the payment of the allowable costs of project facilities; and all other moneys appropriated or transferred to the fund. Moneys in the loan guarantee fund in excess of four per cent of the unpaid principal amount of loan repayments guaranteed under section 166.06 of the Revised Code, but subject to the provisions and requirements of any guarantee contracts, may be transferred to the facilities establishment fund by the treasurer of state upon the order of the director of development. Moneys received by the state under Chapter 122. of the Revised Code, to the extent allocable to the utilization of moneys derived from proceeds of the sale of obligations pursuant to section 166.08 of the Revised Code, shall be credited to the facilities establishment fund.

(B) All moneys appropriated or transferred to the facilities establishment fund may be released at the request of the director for payment of allowable costs or the making of loans under this chapter, for

transfer to the loan guarantee fund established in section 166.06 of the Revised Code or, after consultations with the development financing policy board, for use for the purpose of or transfer to the funds established by sections 122.35, 122.42, 122.54, 122.55, 122.56, 122.561 [122.56.1], 122.57, and 122.82 of the Revised Code, but only for such of those purposes as are within the authorization of Section 13 of Article VIII of the Constitution of Ohio, in all cases subject to the approval of the controlling board.

HISTORY: 138 v S 313 (Eff 5-2-80); 139 v H 536 (Eff 8-12-82); 140 v S 227, Eff 7-14-83.

Cross-References to Related Sections

Deposit and disposition of moneys, RC § 122.35.

Moneys to be kept in depositories selected by commission; exceptions, RC § 122.82.

Research Aids

Economic development program:

O-Jur2d: Industrial, economic and community development § 5

Am-Jur2d: Pub F §§ 55—59

§ 166.04 [Director to determine whether assistance will conform to chapter; notice of application for assistance.]

(A) Prior to entering into each agreement to provide assistance under this chapter, the director of development shall determine whether the assistance will conform to the requirements of Chapter 166. of the Revised Code. Such determination, and the facts upon which it is based, shall be set forth by the director in submissions made to the controlling board for purposes of section 166.03 and to the development financing advisory board under section 166.05 of the Revised Code. An agreement to provide assistance under this chapter shall set forth such determination, which shall be conclusive for purposes of the validity and enforceability of such agreement and any loan guarantees, loans, or other agreements entered into pursuant to such agreement to provide assistance.

(B) Whenever a person applies for financial assistance under this chapter and the project for which assistance is requested is to relocate facilities that are currently being operated by the person and that are located in another county, municipal corporation, or township, the director shall provide written notification to the appropriate local governmental bodies and state officials. The notification shall contain the following information:

(1) The name of the person applying for financial assistance under this chapter;

(2) The county, and the municipal corporation or township, in which the project for which assistance is requested is located; and

(3) The county, and the municipal corporation or township, in which the facility to be replaced is located.

The director shall provide the written notification to the appropriate local governmental bodies and state officials so that they receive the notification at least five days before the development financing advisory board meeting at which the board considers the request for financial assistance pursuant to section 166.05 of the Revised Code.

(C) As used in division (B) of this section:

(1) "Appropriate local governmental bodies" means:

(a) The boards of county commissioners or legislative authorities of the county in which the project for which assistance is requested is located and of the county in which the facility to be replaced is located;

(b) The legislative authority of the municipal corporation or the board of township trustees of the township in which the project for which assistance is requested is located; and

(c) The legislative authority of the municipal corporation or the board of township trustees of the township in which the facility to be replaced is located.

(2) "State officials" means:

(a) The state representative and state senator in whose districts the project for which assistance is requested is located;

(b) The state representative and state senator in whose districts the facility to be replaced is located.

HISTORY: 138 v S 313 (Eff 5-2-80); 139 v H 536 (Eff 8-12-82); 140 v H 260 (Eff 8-27-83); 140 v S 227, Eff 7-14-83.

Research Aids

Economic development program:

O-Jur2d: Industrial, economic and community developments § 5

§ 166.05 [Criteria for selecting projects to be assisted: nature, amount and terms; determination that benefits exceed cost; development advisory committee created.]

(A) In determining the projects to be assisted and the nature, amount and terms of assistance to be provided for an eligible project under Chapter 166. of the Revised Code:

(1) The director of development shall take into consideration all of the following:

(a) The number of jobs to be created or preserved, directly or indirectly;

(b) Payrolls, and the taxes generated, at both state and local levels, by the eligible project and by the employment created or preserved by the eligible project;

(c) The size, nature, and cost of the eligible project, including the prospect of the project for providing long-term jobs in enterprises consistent with the changing economics of the state and the nation;

(d) The needs, and degree of needs, of the area in which the eligible project is to be located;

(e) The needs of any private sector enterprise to be assisted;

(f) The competitive effect of the assistance on other enterprises providing jobs for people of the state;

(g) The amount and kind of assistance, if any[,] to be provided to the private sector enterprise by other governmental agencies through tax exemption or abatement, financing assistance with industrial development bonds, and otherwise, with respect to the eligible project;

(h) The impact of the eligible project and its operations on local government services, including school services, and on public facilities;

(i) The effect of the assistance on the loss of or damage to or destruction of prime farmland, or the removal from agricultural production of prime farmland. As used in this section, "prime farmland" means agricultural land that meets the criteria for this classification as defined by the United States soil conservation service.

(j) The length of time the operator of the project has been operating facilities within the state;

(k) The reservation of financial assistance made by the general assembly for small business concerns.

(2) The benefits to the local area, including taxes, jobs, and reduced unemployment and reduced welfare costs, among others, may be accorded value in the leasing or sales of project facilities and in loan and guarantee arrangements.

(B) Prior to his final approval of the assistance to be provided, the director shall determine that the benefits to be derived by the state and local area from the establishment or development, and operation, of the eligible project will exceed the cost of providing such assistance and shall submit to the development financing advisory board and to the controlling board a copy of such determination including the basis for such determination.

(C) Prior to the submission provided for in division (B) of this section to the controlling board, the director shall submit to the development financing advisory board data pertinent to the considerations set forth in division (A) of this section, the terms of the proposed assistance, and such other relevant information as the development financing advisory board may request.

(D) The development financing advisory board shall, on the basis of such data, make recommendations as to the appropriateness of the assistance to be provided. Such recommendations may be revised to reflect any changes in the proposed assistance as the director may submit to the board. The recommendations, as amended, of the board as to the appropriateness of the proposed assistance shall be submitted to the controlling board.

(E) Financial statements and other data submitted to the director of development, the development financing advisory board, or the controlling board by any private sector person in connection with financial assistance under this chapter, or any information taken from such statements or data for any purpose, shall not be open to public inspection. The development financing advisory board in considering confidential information in connection with financial assistance under this chapter may, only for consideration of the confidential information referred to, and in the manner provided in division (E) of section 121.22 of the Revised Code, close the meeting during such consideration.

HISTORY: 138 v S 313 (Eff 5-2-80); 139 v H 336 (Eff 6-12-82); 140 v S 227. Eff 7-14-83.

Cross-References to Related Sections

Application for financial assistance, RC § 166.04.

Research Aids

Economic development program:
C-Jur2d: Industrial, economic and community development § 5

§ 166.06 [Director may enter into contracts to guarantee repayment of loans from loan guarantee fund.]

(A) Subject to any limitations as to aggregate amounts thereof that may from time to time be prescribed by the general assembly and to other applicable provisions of this chapter, the director of development may, on behalf of the state, enter into contracts to guarantee the repayment or payment of not more than ninety per cent of the unpaid principal amount of loans made, including bonds, notes, or other certificates issued or given to provide funds, to pay allowable costs of eligible projects. Such guarantees shall be secured solely by and payable solely from the loan guarantee fund created by this section and from the moneys representing gross profits payable to the state from the sale of spirituous liquor as included in the definition of "pledged receipts" in division (A)(6) of section 166.08 of the Revised Code, in the manner and to the extent provided in such guarantee contracts consistent with this section. Such guarantees shall not constitute general obligations of the state or of any political subdivision, and moneys raised by taxation shall not be obligated or pledged for the payment of such guarantees.

(B) Before guaranteeing any such repayments or payments the director shall determine that:

(1) The project is an eligible project and is economically sound;

(2) The principal amount to be guaranteed does not exceed ninety per cent of the allowable costs of the eligible project as determined by an independent engineer, architect, or appraiser engaged by the director by separate contract relating separately and solely to the particular eligible project for which the guarantee is to be made and to be paid solely from the facilities establishment fund. Such contract shall be subject to controlling board approval prior to making such an appraisal.

(3) The principal amount to be guaranteed has a satisfactory maturity date or dates, which in no case shall be later than twenty-five years from the effective date of the guarantee;

(4) The rate of interest on the loan to be guaranteed and on any other loan made by the same parties or related persons for the eligible project is not excessive;

(5) The principal obligor, or primary guarantor, is responsible and is reasonably expected to be able to meet the payments under the loan, bonds, notes, or other certificates;

(6) The loan or documents pertaining to the bonds, notes, or other certificates to be guaranteed contains amortization provisions satisfactory to the director requiring periodic payments or sinking fund or similar deposits by the principal obligor, and is in such form and contains such terms and provisions for the protection of the lenders as are generally consistent with commercial practice, including, where applicable, provisions with respect to property insurance, repairs, alterations, payment of taxes and assessments, delinquency charges, default remedies, acceleration of maturity, prior, additional and secondary liens, and other matters as the director may approve.

The determinations of the director shall be conclusive for purposes of the validity of a guarantee evidenced by a contract signed by the director, and such guarantee shall be incontestable as to moneys advanced under loans to which such guarantees are by their terms applicable.

(C) The contract of guarantee may make provision for the conditions of, time for and manner of fulfillment of the guarantee commitment, subrogation of the state to the rights of the parties guaranteed and exercise of such parties' rights by the state, giving the state the options of making payment of the principal amount guaranteed in one or more installments and, if deferred, to pay interest thereon from the loan guarantee fund and pledged receipts described in division (A)(6) of section 166.08 of the Revised Code, any other terms or conditions customary to such guarantees and as the director may approve, and may contain provisions for securing the guarantee in the manner consistent with this section, covenants on behalf of the state for the maintenance of the loan guarantee fund created by this section and of receipts to it permitted by this chapter, including covenants on behalf of the state to issue obligations under section 166.08 of the Revised Code to provide moneys to the loan guarantee fund to fulfill such guarantees and covenants authorized by division (R)(1) of section 166.08 of the Revised Code, and covenants restricting the aggregate amount of guarantees that may be contracted under this section and obligations that may be issued under section 166.08 of the Revised Code, and terms pertinent to either, to better secure the parties guaranteed.

(D) The "loan guarantee fund" of the economic development program is hereby created as a special revenue fund and a trust fund which shall be in the custody of the treasurer of state but shall be separate and apart from and not a part of the state treasury to consist of all grants, gifts, and contributions of moneys or rights to moneys lawfully designated for or deposited in such fund, all moneys and rights to moneys lawfully appropriated and transferred to such fund, including moneys received from the issuance of obligations under section 166.08 of the Revised Code, and moneys deposited to such fund pursuant to division (F) of this section; provided that the loan guarantee fund shall not be comprised, in any part, of moneys raised by taxation.

(E) The director may fix service charges for making a guarantee. Such charges shall be payable at such times and place and in such amounts and manner as may be prescribed by the director.

(F) The treasurer of state shall serve as agent for the director in the making of deposits and withdrawals and maintenance of records pertaining to the loan guarantee fund. Funds from the loan guarantee fund shall be disbursed under a guarantee made pursuant to this section to satisfy a guaranteed repayment or payment which is in default. The treasurer of state shall first withdraw and transfer moneys then on deposit in the loan guarantee fund. Whenever these moneys are inadequate to meet the requirements of a guarantee, the treasurer of state shall, without need of appropriation or further action by the director, provide for a withdrawal and transfer to the loan guarantee fund and then to the guaranteed party of moneys in such amount as is necessary to meet the guarantee, from moneys representing gross profits payable to the state from the sale of spirituous liquor as are included in the definition of "pledged receipts" in division (A)(6) of section 166.08 of the Revised Code. Such disbursements shall be made in the manner and at the times provided in such guarantees.

(G) Any guaranteed parties under this section, except to the extent that their rights are restricted by the guarantee documents, may by any suitable form of legal proceedings, protect and enforce any rights under the laws of this state or granted by such guarantee or guarantee documents. Such rights include the right to compel the performance of all duties of the director and the treasurer of state required by this section or the guarantee or guarantee documents; and in the event of default with respect to the payment of any guarantees, to apply to a court having jurisdiction of the cause to appoint a receiver to receive and administer the moneys pledged to such guarantee with full power to pay, and to provide for payment of, such guarantee, and with such powers, subject to the direction of the court, as are accorded receivers in general equity cases, excluding any power to pledge or apply additional revenues or receipts or other income or moneys of the state or

governmental agencies of the state to the payment of such guarantee. Each duty of the director and the treasurer of state and their officers and employees, and of each governmental agency and its officers, members, or employees, required or undertaken pursuant to this section or a guarantee made under authority of this section, is hereby established as a duty of the director and the treasurer of state, and of each such officer, member, or employee having authority to perform such duty, specifically enjoined by the law resulting from an office, trust, or station within the meaning of section 2731.01 of the Revised Code. The persons who are at the time the director and treasurer of state, or their officers or employees, are not liable in their personal capacities on any guarantees or contracts to make guarantees by the director.

HISTORY: 138 v S 313 (Eff 5-2-80); 139 v H 536. Eff 8-12-82.

Cross-References to Related Sections

Facilities establishment fund created, RC § 166.03.

Research Aids

Economic development program:
O-Jur2d: Industrial, economic and community development § 5

§ 166.07 [Loans from the facilities establishment fund.]

(A) The director of development, with the approval of the controlling board and subject to the other applicable provisions of this chapter, may lend moneys in the facilities establishment fund to persons for the purpose of paying allowable costs of an eligible project if the director determines that:

(1) The project is an eligible project and is economically sound;

(2) The borrower is unable to finance the necessary allowable costs through ordinary financial channels upon comparable terms;

(3) The amount to be lent from the facilities establishment fund will not exceed seventy-five per cent of the total allowable costs of the eligible project;

(4) The eligible project could not be achieved in the local area in which it is to be located if the portion of the project to be financed by such loan were instead to be financed by a loan guaranteed under section 166.06 of the Revised Code;

(5) The amount of the loan from the facilities establishment fund to be repaid will be adequately secured by a mortgage, lien, assignment, or pledge, at such level of priority as the director may require.

(B) The determinations of the director under division (A) of this section shall be conclusive for purposes of the validity of a loan commitment evidenced by a loan agreement signed by the director.

(C) Fees, charges, rates of interest, times of payment of interest and principal, and other terms, conditions, and provisions of and security for loans made from the facilities establishment fund pursuant to this section shall be such as the director determines to be appropriate and in furtherance of the purpose for which the loans are made. The moneys used in making such loans shall be disbursed from the facilities establishment fund upon order of the director.

(D) The director is authorized to take such actions as may be necessary or appropriate to collect or otherwise deal with any loan made under this section.

(E) The director may fix service charges for the making of a loan. Such charges shall be payable at such times and place and in such amounts and manner as may be prescribed by the director.

HISTORY: 138 v S 313 (Eff 5-2-80); 139 v H 536 (Eff 8-12-82); 139 v S 330 (Eff 6-25-82); 140 v S 227. Eff 7-14-83.

Research Aids

Economic development program:
O-Jur2d: Industrial, economic and community development § 5
Am-Jur2d: Pub F §§ 3—5

§ 166.03 [Issuance of obligations; refunding; anticipation notes; pledge of receipts; economic development bond service fund created; tax exemption.]

(A) As used in this section:

(1) "Bond proceedings" means the resolution, order, trust agreement, indenture, lease, and other agreements, amendments and supplements to the foregoing, or any one or more or combination thereof, authorizing or providing for the terms and conditions applicable to, or providing for the security of, obligations issued pursuant to this section, and the provisions contained in such obligations.

(2) "Bond service charges" means principal, including mandatory sinking fund requirements for retirement of obligations, and interest, and redemption premium, if any, required to be paid by the state on obligations.

(3) "Bond service fund" means the applicable fund and accounts therein created for and pledged to the payment of bond service charges, which may be, or may be part of, the economic development bond service fund created by division (S) of this section including all moneys and investments, and earnings from investments, credited and to be credited thereto.

(4) "Issuing authority" means the treasurer of state, or the officer who by law performs the functions of such officer.

(5) "Obligations" means bonds, notes, or other evidence of obligation including interest coupons pertaining thereto, issued pursuant to this section.

(6) "Pledged receipts" means all receipts of the state representing the gross profit on the sale of

spirituous liquor, as referred to in division (B)(4) of section 4301.10 of the Revised Code, after paying all costs and expenses of the department of liquor control and providing an adequate working capital reserve for the department of liquor control as provided in that division, but excluding the sum required by the second paragraph of section 4301.12 of the Revised Code, as in effect on May 2, 1980, to be paid into the state treasury; accrued interest received from the sale of obligations; income from the investment of the special funds; and any gifts, grants, donations, and pledges, and receipts therefrom, available for the payment of bond service charges.

(I) "Special funds" or "funds" means, except where the context does not permit, the bond service fund, and any other funds, including reserve funds, created under the bond proceedings, and the economic development bond service fund created by division (S) of this section to the extent provided in the bond proceedings, including all moneys and investments, and earnings from investment, credited and to be credited thereto.

(B) Subject to the limitations provided in section 166.11 of the Revised Code, the issuing authority, upon the certification by the director of development to the issuing authority of the amount of moneys or additional moneys needed in the facilities establishment fund or the loan guarantee fund for the purpose of paying, or making loans for, allowable costs from the facilities establishment fund, or needed for capitalized interest, for funding reserves, and for paying costs and expenses incurred in connection with the issuance of the obligations, or providing moneys for the loan guarantee fund, as provided in Chapter 166. of the Revised Code or needed for the purposes of funds established in accordance with or pursuant to sections 122.35, 122.42, 122.54, 122.55, 122.56, 122.561 [122.56.1], 122.57, and 122.62 of the Revised Code which are within the authorization of Section 13 of Article VIII of the Constitution of Ohio, shall issue obligations of the state under this section in the required amount; provided that such obligations may be issued to the extent necessary to satisfy the covenants in contracts of guarantee made under section 166.06 of the Revised Code to issue obligations to meet such guarantees, notwithstanding limitations otherwise applicable to the issuance of obligations under this section. The proceeds of such obligations, except for such portion to be deposited in special funds, including reserve funds, as may be provided in the bond proceedings, shall as provided in the bond proceedings be deposited by the director of development, after consultation with the development financing policy board, to the facilities establishment fund or the loan guarantee fund established by section 166.16 of the Revised Code. The issuing authority may appoint trustees, paying agents, and transfer agents and may retain the services of financial advisors, accounting experts, and attorneys, and retain or contract for the services of other consultants and independent contractors, including printing services, as are necessary in the issuing authority's judgment to carry out this section. The costs of such services are allowable costs payable from the facilities establishment fund.

(C) The holders or owners of such obligations shall have no right to have moneys raised by taxation obligated or pledged, and moneys raised by taxation shall not be obligated or pledged, for the payment of bond service charges. Such holders or owners shall have no rights to payment of bond service charges from any moneys accruing to the state from the lease, sale, or other disposition, or use, of project facilities, or from payment of the principal of or interest on loans made, or fees charged for guarantees made, or from any money or property received by the director, treasurer of state, or the state under Chapter 122. of the Revised Code, or from any other use of the proceeds of the sale of the obligations, and no such moneys may be used for the payment of bond service charges, except for accrued interest, capitalized interest, and reserves funded from proceeds received upon the sale of the obligations. The right of such holders and owners to payment of bond service charges shall be limited to all or that portion of the pledged receipts and those special funds pledged thereto pursuant to the bond proceedings in accordance with this section, and each such obligations shall bear on its face a statement to that effect.

(D) Obligations shall be authorized by resolution or order of the issuing authority and the bond proceedings shall provide for the purpose thereof, the principal amount, the principal maturity or maturities, not exceeding twenty-five years from the date of issuance, the interest rate or rates or the maximum interest rate, the date of the obligations and the dates of payment of interest thereon, their denomination, and the establishment within or without the state of a place or places of payment of bond service charges. The purpose of such obligations may be stated in the bond proceedings in terms describing the general purpose or purposes to be served. The bond proceedings shall also provide, subject to the provisions of any other applicable bond proceedings, for the pledge of all, or such part as the issuing authority may determine, of the pledged receipts and the applicable special fund or funds to the payment of bond service charges, which pledges may be made either prior or subordinate to other expenses, claims, or payments, and may be made to secure the obligations on a parity with obligations theretofore or thereafter issued, if and to the extent provided in the bond proceedings. The pledged receipts and special funds so pledged and thereafter received by the state are immediately subject to the lien of such pledge without any physical delivery thereof or further act, and the lien of any such pledges is valid and binding against all parties having claims of any kind against the state or any

governmental agency of the state, irrespective of whether such parties have notice thereof, and shall create a perfected security interest for all purposes of Chapter 1309. of the Revised Code, without the necessity for separation or delivery of funds or for the filing or recording of the bond proceedings by which such pledge is created or any certificate, statement or other document with respect thereto; and the pledge of such pledged receipts and special funds is effective and the money therefrom and thereof may be applied to the purposes for which pledged without necessity for any act of appropriation. Every pledge, and every covenant and agreement made with respect thereto, made in the bond proceedings may therein be extended to the benefit of the owners and holders of obligations authorized by this section, and to any trustee therefor, for the further security of the payment of the bond service charges.

(E) The bond proceedings may contain additional provisions as to:

(1) The redemption of obligations prior to maturity at the option of the issuing authority at such price or prices and under such terms and conditions as are provided in the bond proceedings;

(2) Other terms of the obligations;

(3) Limitations on the issuance of additional obligations;

(4) The terms of any trust agreement or indenture securing the obligations or under which the same may be issued;

(5) The deposit, investment and application of special funds, and the safeguarding of moneys on hand or on deposit, without regard to Chapter 131. or 135. of the Revised Code, but subject to any special provisions of Chapter 166. of the Revised Code, with respect to particular funds or moneys, provided that any bank or trust company which acts as depository of any moneys in the special funds may furnish such indemnifying bonds or may pledge such securities as required by the issuing authority;

(6) Any or every provision of the bond proceedings being binding upon such officer, board, commission, authority, agency, department, or other person or body as may from time to time have the authority under law to take such actions as may be necessary to perform all or any part of the duty required by such provision;

(7) Any provision which may be made in a trust agreement or indenture;

(8) Any other or additional agreements with the holders of the obligations, or the trustee therefor, relating to the obligations or the security therefor.

(F) The obligations may have the great seal of the state or a facsimile thereof affixed thereto or printed thereon. The obligations and any coupons pertaining to obligations shall be signed or bear the facsimile signature of the issuing authority. Any obligations or coupons may be executed by the person who, on the date of execution, is the proper issuing authority although on the date of such bonds or coupons such person was not the issuing authority. In case the issuing authority whose signature or a facsimile of whose signature appears on any such obligation or coupon ceases to be the issuing authority before delivery thereof, such signature or facsimile is nevertheless valid and sufficient for all purposes as if he had remained the issuing authority until such delivery; and in case the seal to be affixed to obligations has been changed after a facsimile of the seal has been imprinted on such obligations, such facsimile seal shall continue to be sufficient as to such obligations and obligations issued in substitution or exchange therefor.

(G) All obligations are negotiable instruments and securities under Chapter 1308. of the Revised Code, subject to the provisions of the bond proceedings as to registration. The obligations may be issued in coupon or in registered form, or both, as the issuing authority determines. Provision may be made for the registration of any obligations with coupons attached thereto as to principal alone or as to both principal and interest, their exchange for obligations so registered, and for the conversion or reconversion into obligations with coupons attached thereto of any obligations registered as to both principal and interest, and for reasonable charges for such registration, exchange, conversion, and reconversion.

(H) Except as provided in this section, all obligations issued shall be sold at public sale, as determined in the bond proceedings, either to the highest bidder or bidders therefor based on the lowest interest cost to absolute maturity, or to the bidder or combination of bidders bidding the lowest interest rate or combination of rates. Notice of sale of obligations shall be published at least once in one or more newspapers published in and of general circulation in Franklin county and in one or more financial journals, such notice to be published at least ten full days before the date of sale. Each of such published notices shall state: the day, hour, and place of the sale; the total or maximum principal amount and date of the obligations to be sold; and the dates of payment of principal and interest; whether or not they are callable; and information relative to the denominations, and amounts of principal maturities, together with such other information as the issuing authority may determine or authorize, including without limitation thereto, the method of determining the lowest interest cost or lowest combination of interest rates, limitations on interest rates, and any other conditions and terms of the sale. The issuing authority may reject all bids and readvertise and reoffer obligations for sale.

Obligations issued to provide moneys for the loan guarantee fund may, as determined by the issuing authority, be sold at private sale, and without publication of a notice of sale.

(I) Pending preparation of definitive obligations, the issuing authority may issue interim receipts or

certificates which shall be exchanged for such definitive obligations.

(J) In the discretion of the issuing authority, obligations may be secured additionally by a trust agreement or indenture between the issuing authority and a corporate trustee which may be any trust company or bank having its principal place of business within the state. Any such agreement or indenture may contain the resolution or order authorizing the issuance of the obligations, any provisions that may be contained in any bond proceedings, and other provisions which are customary or appropriate in an agreement or indenture of such type, including, but not limited to:

(1) Maintenance of each pledge, trust agreement, indenture, or other instrument comprising part of the bond proceedings until the state has fully paid the bond service charges on the obligations secured thereby, or provision therefor has been made;

(2) In the event of default in any payments required to be made by the bond proceedings, or any other agreement of the issuing authority made as a part of the contract under which the obligations were issued, enforcement of such payments or agreement by mandamus, the appointment of a receiver, suit in equity, action at law, or any combination of the foregoing;

(3) The rights and remedies of the holders of obligations and of the trustee, and provisions for protecting and enforcing them, including limitations on rights of individual holders of obligations;

(4) The replacement of any obligations which become mutilated or are destroyed, lost, or stolen;

(5) Such other provisions as the trustee and the issuing authority agree upon, including limitations, conditions, or qualifications relating to any of the foregoing.

(K) Any holder of obligations or a trustee under the bond proceedings, except to the extent that his rights are restricted by the bond proceedings, may by any suitable form of legal proceedings, protect and enforce any rights under the laws of this state or granted by such bond proceedings. Such rights include the right to compel the performance of all duties of the issuing authority, the director of development, or the department of liquor control required by Chapter 166. of the Revised Code or the bond proceedings; to enjoin unlawful activities; and in the event of default with respect to the payment of any bond service charges on any obligations or in the performance of any covenant or agreement on the part of the issuing authority, the director of development, or the department of liquor control in the bond proceedings, to apply to a court having jurisdiction of the cause to appoint a receiver to receive and administer the pledged receipts and special funds, other than those in the custody of the treasurer of state, which are pledged to the payment of the bond service charges on such obligations or which are the subject of the covenant or agreement, with full power to pay, and to provide for payment of bond service charges on, such obligations, and with such powers, subject to the direction of the court, as are accorded receivers in general equity cases, excluding any power to pledge additional revenues or receipts or other income or moneys of the issuing authority or the state or governmental agencies of the state to the payment of such principal and interest and excluding the power to take possession of, mortgage, or cause the sale or otherwise dispose of any project facilities.

Each duty of the issuing authority and the issuing authority's officers and employees, and of each governmental agency and its officers, members, or employees, undertaken pursuant to the bond proceedings or any agreement or lease, lease-purchase agreement, or loan made under authority of Chapter 166. of the Revised Code, and in every agreement by or with the issuing authority, is hereby established as a duty of the issuing authority, and of each such officer, member, or employee having authority to perform such duty, specifically enjoined by the law resulting from an office, trust, or station within the meaning of section 2731.01 of the Revised Code.

The person who is at the time the issuing authority, or the issuing authority's officers or employees, are not liable in their personal capacities on any obligations issued by the issuing authority or any agreements of or with the issuing authority.

(L) The issuing authority may authorize and issue obligations for the refunding, including funding and retirement, and advance refunding with or without payment or redemption prior to maturity, of any obligations previously issued by the issuing authority. Such obligations may be issued in amounts sufficient for payment of the principal amount of the prior obligations, any redemption premiums thereon, principal maturities of any such obligations maturing prior to the redemption of the remaining obligations on a parity therewith, interest accrued or to accrue to the maturity dates or dates of redemption of such obligations, and any allowable costs including expenses incurred or to be incurred in connection with such issuance and such refunding, funding, and retirement. Subject to the bond proceedings therefor, the portion of proceeds of the sale of obligations issued under this division to be applied to bond service charges on the prior obligations shall be credited to an appropriate account held by the trustee for such prior or new obligations or to the appropriate account in the bond service fund for such obligations. Obligations authorized under this division shall be deemed to be issued for those purposes for which such prior obligations were issued and are subject to the provisions of this section pertaining to other obligations, except as otherwise provided in this section; provided that, unless otherwise authorized by the general assembly, any limitations imposed by the general assembly pursuant to this section with respect to bond service charges applicable to the prior obligations shall be

applicable to the obligations issued under this division to refund, fund, advance refund or retire such prior obligations.

(M) The authority to issue obligations under this section includes authority to issue obligations in the form of bond anticipation notes and to renew the same from time to time by the issuance of new notes, but the maximum maturity of such notes, including renewals thereof, unless otherwise authorized by the general assembly, shall not exceed five years from the date of the issuance of the original notes. The holders of such notes or interest coupons pertaining thereto shall have a right to be paid solely from the pledged receipts and special funds that may be pledged to the payment of the bonds anticipated, or from the proceeds of such bonds or renewal notes, or both, as the issuing authority provides in the resolution or order authorizing such notes. Such notes may be additionally secured by covenants of the issuing authority to the effect that the issuing authority and the state will do such or all things necessary for the issuance of such bonds or renewal notes in appropriate amount, and either exchange such bonds or renewal notes therefor or apply the proceeds thereof to the extent necessary, to make full payment of the principal of and interest on such notes at the time or times contemplated, as provided in such resolution or order. For such purpose, the issuing authority may issue bonds or renewal notes in such principal amount and upon such terms as may be necessary to provide funds to pay when required the principal of and interest on such notes, notwithstanding any limitations prescribed by or for purposes of this section. Subject to this division, all provisions for and references to obligations in this section are applicable to notes authorized under this division.

The issuing authority in the bond proceedings authorizing the issuance of bond anticipation notes shall set forth for such bonds an estimated interest rate and a schedule of principal payments for such bonds and the annual maturity dates thereof, and for purposes of any limitation on bond service charges prescribed under division (A) of section 166.11 of the Revised Code, the amount of bond service charges on such bond anticipation notes shall be deemed to be the bond service charges for the bonds anticipated thereby as set forth in the bond proceedings applicable to such notes, but this provision does not modify any authority in this section to pledge pledged receipts and special funds to, and covenant to issue bonds to fund, the payment of principal of and interest and any premium on such notes.

(N) Obligations issued under this section are lawful investments for banks, societies for savings, building and loan and savings and loan associations, deposit guarantee associations, trust companies, trustees, fiduciaries, insurance companies, including domestic for life and domestic not for life, trustees or other officers having charge of sinking and bond retirement or other special funds of political subdivisions and taxing districts of this state, the commissioners of the sinking fund of the state, the industrial commission, the state teachers retirement system, the public employees retirement system, the school employees retirement system, and the police and firemen's disability and pension fund, notwithstanding any other provisions of the Revised Code or rules adopted pursuant thereto by any governmental agency of the state with respect to investments by them, and are also acceptable as security for the deposit of public moneys.

(O) Unless otherwise provided in any applicable bond proceedings, moneys to the credit of or in the special funds established by or pursuant to this section may be invested by or on behalf of the issuing authority only in notes, bonds, or other obligations of the United States, or of any agency or instrumentality thereof, obligations guaranteed as to principal and interest by the United States, obligations of this state or any political subdivision thereof, and certificates of deposit of any national bank located in this state and any bank, as defined in section 1101.01 of the Revised Code, subject to inspection by the superintendent of banks, and the income from such investments shall be credited to such funds as the issuing authority determines and such investments may be sold at such times as the issuing authority determines or authorizes.

(P) Provision may be made in the applicable bond proceedings for the establishment of separate accounts in the bond service fund and for the application of such accounts only to the specified bond service charges on obligations pertinent to such accounts and bond service fund and for other accounts therein within the general purposes of such fund. Unless otherwise provided in any applicable bond proceedings, moneys to the credit of or in the several special funds established pursuant to this section shall be disbursed on the order of the treasurer of state, provided that no such order is required for the payment from the bond service fund when due of bond service charges on obligations.

(Q) The issuing authority may pledge all, or such portion as the issuing authority determines, of the pledged receipts to the payment of bond service charges on obligations issued under this section, and for the establishment and maintenance of any reserves, as provided in the bond proceedings, and make other provisions therein with respect to pledged receipts as authorized by Chapter 166. of the Revised Code, which provisions shall be controlling notwithstanding any other provisions of law pertaining thereto.

(R) The issuing authority may covenant in the bond proceedings, and any such covenants shall be controlling notwithstanding any other provision of law, that the state and applicable officers and governmental agencies of the state, including the general assembly, shall, so long as any obligations are outstanding:

(1) Maintain statutory authority for and cause to be charged and collected wholesale and retail prices for spirituous liquor sold by the state or its agents so that the pledged receipts shall be sufficient in amount to meet bond service charges, and the establishment and maintenance of any reserves and other requirements provided for in the bond proceedings, and, as necessary, to meet covenants contained in contracts of guarantee made under section 166.06 of the Revised Code;

(2) Take or permit no action, by statute or otherwise, that would impair the exemption from federal income taxation of the interest on the obligations.

(S) There is hereby created the "economic development bond service fund," which shall be in the custody of the treasurer of state but shall be separate and apart from and not a part of the state treasury. All moneys received by or on account of the issuing authority or state agencies and required by the applicable bond proceedings, consistent with this section, to be deposited, transferred, or credited to a bond service fund or the economic development bond service fund, and all other moneys transferred or allocated to or received for the purposes of the fund, shall be deposited and credited to such fund and to any separate accounts therein, subject to applicable provisions of the bond proceedings, but without necessity for any act of appropriation. During the period beginning with the date of the first issuance of obligations and continuing during such time as any such obligations are outstanding, and so long as moneys in the pertinent bond service funds are insufficient to pay all bond services charges on such obligations becoming due in each year, a sufficient amount of the gross profit on the sale of spirituous liquor included in pledged receipts are committed and shall be paid to the bond service fund or economic development bond service fund in each year for the purpose of paying the bond service charges becoming due in that year without necessity for further act of appropriation for such purpose and notwithstanding anything to the contrary in Chapter 4301. of the Revised Code. The economic development bond service fund is a trust fund and is hereby pledged to the payment of bond service charges to the extent provided in the applicable bond proceedings, and payment thereof from such fund shall be made or provided for by the treasurer of state in accordance with such bond proceedings without necessity for any act of appropriation.

(T) The obligations, the transfer thereof, and the income therefrom, including any profit made on the sale thereof, shall at all times be free from taxation within the state.

HISTORY: 135 v S 313 (Eff 5-2-80); 139 v H 526 (Eff 8-12-82); 140 v S 227. Eff 7-14-83.

Cross-References to Related Sections

Facilities establishment fund created, RC § 166.03.

Research Aids

Economic development program:

O-Jur2d: Industrial, economic and community development § 5

Am-Jur2d: Pub F §§ 182—208, 218—229, 251—269, 276—277

§ 166.09 [Disposition of loan repayments, recovery on guarantees and other proceeds.]

There shall be credited to the facilities establishment fund the moneys received by the state from the repayment of loans and recovery on loan guarantees, including interest thereon, made from the facilities establishment fund or from the loan guarantee fund and from the sale, lease, or other disposition of property acquired or constructed from moneys in the facilities establishment fund with moneys derived from the proceeds of the sale of obligations under section 166.08 of the Revised Code. Such moneys shall be applied as provided in this chapter pursuant to appropriations made by the general assembly. Notwithstanding the foregoing, any amounts recovered on loan guarantees shall be deposited to the credit of the loan guarantee fund to the extent necessary to restore that fund to the level required by any guarantee contract.

HISTORY: 138 v S 313. Eff 5-2-80.

Research Aids

Economic development program:

O-Jur2d: Industrial, economic and community development § 5

§ 166.10 [Relationship to other laws and agency powers; severability of provisions.]

The authority provided by Chapter 166. of the Revised Code is in addition to and provides alternative methods for any other authority provided by law for the same or similar purposes, and are supplemental to and not in derogation of any powers of any governmental agency otherwise conferred. In case any section or provision of Chapter 166. of the Revised Code, including any condition or prerequisite to any action or determination, or in case any covenant, stipulation, obligation, resolution, trust agreement, indenture, lease[,] agreement, act, or action, or part thereof, made, assumed, entered into, or taken under Chapter 166. of the Revised Code, or any application thereof, is for any reason held to be illegal or invalid, such illegality or invalidity shall not affect the remainder thereof or any other section or provision of Chapter 166. of the Revised Code, including any condition or prerequisite to any action or determination, or any other covenant, stipulation, obligation, resolution, trust agreement, indenture, lease, agreement, act, or action, or part thereof, made, assumed, entered into, or taken under such chapter, which shall be con-

strued and enforced as if such illegal or invalid portion were not contained therein, nor shall such illegality or invalidity or any application thereof affect any legal and valid application thereof, and each such section, provision, covenant, stipulation, obligation, resolution, trust agreement, indenture, lease, agreement, act, or action, or part thereof, shall be deemed to be effective, operative, made, entered into or taken in the manner and to the full extent permitted by law.

HISTORY: 138 v S 313. Eff 5-2-80.

Research Aids

Economic development program:
O-Jur2d: Industrial, economic and community development § 5

§ 166.11 [Limitations on aggregate amounts of obligations and guarantees; provisions for small businesses.]

(A) The aggregate principal amount of obligations that may be issued under section 166.08 of the Revised Code is three hundred million dollars, plus the principal amount of any such obligations retired by payment, the amounts held for the payment of the principal amount of any such obligations outstanding, amounts in special funds held as reserves to meet bond service charges, and amounts of obligations issued to provide moneys required to meet payments from the loan guarantee fund created in section 166.06 of the Revised Code, and minus the amount if any by which four per cent of the unpaid principal amount of loan repayments guaranteed under section 166.06 of the Revised Code exceeds the amount in the loan guarantee fund. The terms of the obligations issued under section 166.08 of the Revised Code, other than obligations issued to meet guarantees that cannot be satisfied from amounts then held in the loan guarantee fund, shall be such that the aggregate amount of moneys used from profit from the sale of spirituous liquor, and not from other sources, in any fiscal year shall not exceed twenty-five million dollars. For purposes of the preceding sentence, "other sources" include the annual investment income on special funds to the extent it will be available for payment of any bond service charges in lieu of use of profit from the sale of spirituous liquor, and shall be estimated on the basis of the expected funding of those special funds and assumed investment earnings thereon at a rate equal to the weighted average yield on investments of those special funds determined as of any date within sixty days immediately preceding the date of issuance of the bonds in respect of which the determination is being made. The determinations required by this division shall be made by the treasurer of state at the time of issuance of an issue of obligations and shall be conclusive for purposes of such issue of obligations from and after their issuance and delivery.

(B) The aggregate amount of the guaranteed portion of the unpaid principal of loans guaranteed under section 166.06 of the Revised Code and the unpaid principal of loans made under section 166.07 of the Revised Code may not at any time exceed five hundred million dollars.

(C) At least fifty per cent of the original amounts authorized by division (B) of this section shall be reserved for and applied to assist small business concerns that have not more than four hundred employees, not including new employment to be generated by the eligible project to be assisted under this chapter, but this requirement does not limit the portion of such amounts which may be applied to assist such small business concerns.

HISTORY: 138 v S 313 (Eff 5-2-80); 140 v S 227. Eff 7-14-83.

Cross-References to Related Sections

Issuance of bonds, notes, other obligations, RC § 9.96.

Research Aids

Economic development program:
O-Jur2d: Industrial, economic and community development § 5

EXHIBIT C

PRIVATE LETTER RULING WHICH DETERMINED THE

TAX-EXEMPT (NON-IDB) STATUS OF THE 166 PROGRAM

Index No. 0103.02-00

The Honorable James A. Rhodes
The Governor of Ohio
State House
Columbus, OH 43215

Richard R. Grosgebauer
(202) 566-4077

T:I:I:1:3
FEB 01 1982

State = Ohio
Bonds = State of Ohio Economic Development Bonds, Series 1981

Dear Governor Rhodes:

This letter supplements the ruling issued to the State on December 17, 1981, concerning the tax-exempt status of interest paid on the Bonds. The second paragraph on page 7 of the ruling is hereby amended to read as follows:

> Because the Bonds are obligations of the State and constitute neither industrial development bonds within the meaning of section 103(b) of the Code, nor arbitrage bonds within the meaning of Section 103(c), we conclude that interest on the Bonds will be excludable from the gross income of the recipients thereof as provided in section 103(a)(1).

In accordance with the power of attorney on file in this office, we are sending copies of this letter to your authorized representatives.

Sincerely yours,

(signed) Anthony Manzanares, Jr.
Chief, Individual Income Tax Branch

"This document may not be used or cited as precedent. Section 6110(j)(3) of the Internal Revenue Code."

Index No.: 4103.00-00

This document may not be used or cited as precedent. Section 6110(j)(5) of the Internal Revenue Code.

The Honorable James A. Rhodes
The Governor of Ohio
State House
Columbus, OH 43215

Richard W. Grossbauer
(202) 566-4877
T:I:I:1:3

DEC 17 1981

State = Ohio
Bonds = State of Ohio Economic Development Bonds, Series 1981
Act = Chapter 166 of the Revised Code of Ohio

Dear Governor Rhodes:

This is in reply to a letter of July 2, 1981, in which certain rulings concerning section 103 of the Internal Revenue Code are requested on behalf of the State.

The information submitted indicates that, in 1980, the State established its Economic Development Program (the Program) pursuant to the Act. The Program is designed to induce development in economically distressed areas of the State by providing financial assistance for eligible capital projects located in those areas. Financial assistance can be provided directly to private sector enterprise for eligible capital projects used directly in business, or to governmental agencies for public capital improvements. Financial assistance to the private sector can be in the form of direct capital investment by the State in facilities for sale, lease or other disposition to private companies; direct loans to private companies; or State guarantees of loans to private companies made by private lenders. Financial assistance to governmental agencies can be in the form of contracts to provide public capital improvements or loans or grants therefore.

Pursuant to section 166.08 of the Act, the Treasurer of the State proposes to issue the bonds in the principal amount of $20 million to provide the initial funds for the Program. Approximately $18 million of the proceeds from the Bonds will be deposited in the Facilities Establishment Fund, a revolving fund from which the State will make direct investments in eligible capital projects and direct loans to private companies. The majority of the funds deposited in the Facilities Establishment Fund will be used to finance facilities that will be used in the trade or business of nonexempt persons, as defined in section 103(b)(3) of the Code. Such facilities will not be exempt facilities described in sections 103(b)(4) and (6). Approximately $2 million of the proceeds from the Bonds will be deposited in a Loan Guarantee Fund to provide funds needed to meet guarantees arising from the State's guarantees of loans made by private lenders for eligible projects. Additional bonds will be issued, as needed, primarily to fund the Facilities Establishment Fund and for other purposes incidental to the Program.

The proceeds of a bond issue may, in part, be used to fund a debt service reserve account for one or more issues. It is represented that the proceeds so used will not exceed that in reasonably required based on market considerations and professional advice, and in any event will not exceed the greater of 1.5 times the highest annual debt service on the bonds or 15 percent of the original face amount of the issue.

Pursuant to section 166.05(A)(1) of the Act, determinations to provide assistance for eligible projects are based on several factors, including: the needs of the local area and of the company to be assisted; the number of jobs to be created or preserved; the scope and cost of the project and the likelihood that it will afford permanent jobs consistent with the changing economy of the area; payroll and state and local taxes to be generated; the impact on local services; and environmental and conservation factors. The benefits to the local area are to be accorded value in determining the terms and amounts of financial assistance and may provide sufficient consideration to warrant sales of land or improvements by the State with little or no direct monetary payment by the company to the State, or loans with very low or no interest charges.

It is represented that payments and repayments made to the State by, or on behalf of companies assisted under the Program will not be adequate on a cash flow basis to meet current bond service charges, and that the present value of such payments and repayments will not exceed 90 percent of the present value of the total bond service charges. In addition, section 166.09 of the Act requires that any payments made to the State by such companies be deposited in the Facilities Establishment Fund and used to finance additional eligible projects. Therefore, such payments will not be used, either directly or indirectly, to secure or pay Bond service charges. The Bonds will be special fund obligations of the State secured by a pledge of the State's liquor receipts and certain minor items such as capitalized and accrued interest, reserve funds provided from Bond proceeds, and interest earned on reserves in the Bond service fund. The portion of the State's liquor receipts pledged to and used for Bond service charges is to be drawn from the net operating income of the State's liquor sales (the Liquor Control Fund) which otherwise would have been transferred to the General Revenue Fund of the State to be used for general purposes of the State. No payments made to the State by assisted companies will go directly or indirectly into the Liquor Control Fund or the General Revenue Fund.

The Department of Liquor Control will transfer to the Treasurer of the State, for deposit in the Bond service fund, the amount of net liquor receipts needed to meet the principal of and interest on the Bonds. There will be a proper matching of revenues and debt service within each bond year in the Bond service fund. It is represented that, at no time during any year will the Bond service fund contain a total amount in excess of the aggregate of those amounts which, when determined separately for each issue of bonds outstanding, would be expended to pay the annual debt service for such issue, except for an amount not exceeding the greater of one year's earnings on the amount allocated to a bond issue or one-twelfth of annual debt service on such issue. Except for such Bond service fund and the bond service reserve fund described earlier, there will be no debt service fund, redemption fund, replacement fund or any similar fund which is either pledged to or which the State reasonably expects to be used for, the payment of principal or interest on any issue of bonds.

In addition to the representations made above, the following representations are made with respect to the bonds to be issued under the Program: All of the proceeds credited to the Facilities Establishment Fund will be committed to eligible projects within one year from the date of issuance of the bonds; within six months after issuance of the bonds, the State will incur an obligation of $100,000 or more to commence or acquire one or more eligible projects and work on or acquisition of each eligible project will proceed to completion with due diligence; no less than 85 percent of the spendable proceeds allocable to the bond issue will be expended on the costs of eligible projects within three years after issuance; any earnings allocable to investment of proceeds of a bond issue that are deposited in the Facilities Establishment Fund will be expended for the purposes for which the bonds were issued within three years after issuance; any accrued interest or premium received upon delivery of a bond issue, and any earnings from investments in a bond service fund or bond service reserve fund will be applied to meet current bond service charges within one year after receipt; the aggregate amount of proceeds of a bond issue, including earnings from investments, which is invested after applicable temporary periods at a yield materially higher than the yield on the bonds, together with any amount of reserve funds and the Loan Guarantee Fund, will not exceed 15 percent of the proceeds of such issue after deducting issuance costs; no bonds will be issued that are not necessary for purposes of the Program nor will bonds be issued sooner or remain outstanding longer than is necessary; and no bond proceeds will be used to replace moneys used to acquire taxable securities or obligations or to replace any proceeds of a prior matured issue.

The following rulings are requested:

1. The Bonds are obligations of a "State" within the meaning of section 103(a)(1) of the Code, and the interest thereon is excludable from gross income.

2. The Bonds are not "industrial development bonds" within the meaning of section 103(b) of the Code.

3. The Bonds are not arbitrage bonds within the meaning of section 103(c) of the Code.

Section 103(a)(1) of the Code provides that gross income does not include interest on obligations of a State, a Territory or a possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia.

Section 1.103-1(b) of the Income Tax Regulations provides that section 103(a)(1) of the Code applies to obligations that are to be satisfied out of special funds and not out of general funds or taxes.

In the present case, the Bonds are to be issued by the Treasurer of the State and will be paid with the State's receipts from liquor sales. Accordingly, the Bonds will be obligations of the State.

Section 103(b)(1) of the Code provides that, subject to certain exceptions, interest on any industrial development bond is not excludable from gross income under section 103(a).

Section 103(b)(2) of the Code defines an industrial development bond as any obligation (A) which is issued as part of an issue all or a major portion of the proceeds of which are to be used directly or indirectly in any trade or business carried on by any person who is not an exempt person, and (B) the payment of principal or interest on which is, in whole or in major part, secured by an interest in property used or to be used in a trade or business or in payments in respect of such property, or to be derived from payments in respect of property, or borrowed money, used or to be used in a trade or business.

Section 1.103-7(b)(4) of the regulations provides, in part, that the security interest test relates to the nature of the security for, and the source of the payment of, either the principal or interest on a bond issue. These considerations may be determined from the terms of the bond indenture or on the basis of an underlying agreement.

An underlying arrangement will be inferred if the payments to be made by the industrial user or users and the debt service on the bonds are approximately equal in present value. Other facts that tend to show an underlying arrangement are, first, that payments made by an industrial user or users are material to the security for the bonds, and second, that the identity of the industrial user or users can be determined with reasonable certainty at the time of issue.

In Rev. Rul. 80-309, 1980-2 C.B. 42, a political subdivision issued revenue bonds and used the proceeds to construct terminals and related aircraft facilities which were leased to commercial airlines under long-term leases. The bond indenture provided that the principal of and the interest on the bonds would be payable solely from the revenues derived by the political subdivision from the operation of a toll bridge. However, the payments by the airlines under their leases and the debt service on the bonds were approximately equal in present value, and the extra revenues from the airline leases were available to replace the toll bridge revenues. Accordingly, the revenue ruling concludes that the bonds issued by the political subdivision are industrial development bonds within the meaning of section 103(b)(2) of the Code. See also Rev. Rul. 80-251, 1980-2 C.B. 48.

Example 14 of section 1.103-7(c) of the regulations describes a situation in which J, a political subdivision, will issue several series of bonds to rehabilitate and construct buildings to be leased or sold to nonexempt persons for use in their trades or businesses. Although J will be unconditionally obligated to pay the principal and interest on the bonds, and there is no arrangement whereby revenues from any project will be pledged as security for payment of the bonds, it is apparent that J requires the revenues from the lease and sale of buildings to nonexempt persons in order to pay in full the principal and interest on the bonds. The example concludes that the bonds are

industrial development bonds because, pursuant to an underlying arrangement, payment of the principal and interest is, in major part, to be derived from payments in respect of property or borrowed money used in the trade or business of nonexempt persons.

In the present case, the proceeds of the Bonds will be used to finance facilities that will be used in the trades or businesses of nonexempt persons. However, no portion of any payment made to the State by a company assisted under the Program will be used, either directly or indirectly, to secure or to pay principal or interest on the Bonds. Debt service on the bonds will be paid with the State's liquor receipts. Such receipts will be drawn from the State's Liquor Control Fund which otherwise would have been transferred to the State's General Revenue Fund. Pursuant to section 166.09 of the Act, payments made to the State by assisted companies must be deposited in the Facilities Establishment Fund and used to finance additional eligible projects; therefore, such payments will not be available to replace liquor receipts drawn from the Liquor Control Fund. In addition, it is represented that the present value of the payments made to the State by assisted companies will be substantially less than the present value of the debt service on the Bonds.

Based on the above representations, we conclude that the security interest test set forth in section 103(b)(2)(C) of the Code is not met. Accordingly, the Bonds will not be industrial development bonds within the meaning of section 103(b)(2).

Section 103(c)(1) of the Code provides that, with certain minor exceptions, the interest on any arbitrage bond will not be excludable from gross income.

Section 103(c)(2) of the Code provides that the term "arbitrage bond" means any obligation that is issued as part of an issue all or a major portion (more than 15 percent) of the proceeds of which are reasonably expected to be used directly or indirectly (A) to acquire securities or obligations that may be reasonably expected at the time of issuance of such issue, to produce a yield over the term of the issue that is materially higher than the yield on obligations of such issue, or (B) to replace funds that were used directly or indirectly to acquire securities or obligations described in section 103(c)(2)(A).

Section 103(c)(4)(A) of the Code provides that an obligation shall not be treated as an arbitrage bond solely by reason of the fact that the proceeds of the issue of which such obligation is a part may be invested for a temporary period in securities or other obligations until such proceeds are needed for the purpose for which such issue was issued.

Section 103(c)(4)(B) of the Code provides that an obligation shall not be treated as an arbitrage bond solely by reason of the fact that an amount of the proceeds of the issue of which such obligation is a part may be invested

in securities or other obligations which are part of a reasonably required reserve or replacement fund. The amount in the fund may not exceed 15 percent of the proceeds of the issue unless the issuer establishes that a higher amount is necessary.

Section 1.103-13(b)(12) of the regulations provides that a debt service fund is a fund that is used primarily to achieve a proper matching of revenue and debt service within each bond year. A bona fide debt service fund for a single issue must be depleted at least once a year except for a reasonable carryover amount (not to exceed the greater of one year's earnings on the fund or one-twelfth of annual debt service).

Section 1.103-14(f) of the regulations expands further upon the temporary period permitted under section 103(c)(4) of the Code. Section 1.103-14(b)(1) provides, in general, that original proceeds and investment proceeds of an issue of governmental obligations that are invested to acquire obligations during a 3-year period (or the period determined under section 1.103-14(b)(5) of the regulations) beginning on the date of issue are invested for a temporary period if the "expenditure test," "time test," and "due diligence test" of paragraph (b)(2), (3) and (4) of this section are satisfied.

The "expenditure test" of paragraph (b)(2) provides, generally, that 85 percent of spendable proceeds must be expended on the project or projects by the end of the period described in paragraph (b)(1) of this section which applies to the issue. In the case of an election under section 1.103-13(b)(2)(i)(f) of the regulations (relating to materially higher), it is necessary that 45 percent of spendable proceeds be expended by the end of the 2-year period, and 85 percent by the end of the 4-year period beginning on the date of issue.

The "time test" of paragraph (b)(3) requires, generally, that within 6 months after the date of issue of the governmental obligations, the state or local governmental unit must incur a substantial binding obligation to commence or acquire the project or projects, whether or not identified on the date of issue, to be financed by the issue. A binding obligation to expend the lesser of (i) an amount equal to 5 percent of that portion of the estimated total project cost financed by the issue of governmental obligations and by prior issues, or (ii) $100,000 shall be substantial.

The "due diligence test" of paragraph (b)(4) states that after a substantial binding obligation to acquire or construct the project or projects is incurred, work on or acquisition of the project or projects must proceed with due diligence to completion.

Section 1.103-12(a)(2)(i) of the regulations provides that, under section 103(c)(2) of the Code, the determination whether an obligation is an arbitrage bond depends on the issuer's reasonable expectations, as of the date of issue, regarding the amount and use of the proceeds of the issue.

Based on the facts presented and representations made, we conclude that the Bonds will not be arbitrage bonds within the meaning of section 103(c)(2) of the Code.

Because the Bonds are obligations of the State and constitute neither industrial development bonds within the meaning of section 103(b) of the Code, nor arbitrage bonds within the meaning of section 103(c), we conclude that interest on the Bonds will be excludible from the gross income of the recipients thereof as provided in section 103(a)(1), except to the extent that interest is paid on any bond held by a "substantial user" or "related person," as such terms are defined in section 103(b)(9).

In accordance with the valid power of attorney on file in this office, we are sending a copy of this letter to your authorized representatives.

This ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely yours,

(signed) Anthony Manzanarez, Jr.

Chief, Individual Income Tax Branch

Enclosure
Copy for section 6110 purposes

EXHIBIT D

LIST OF PROJECTS WHICH COULD NOT BE FINANCED IF THE PROPOSED IDB REGULATIONS WERE IN EFFECT FOR THE PAST TWO YEARS

BASED ON 50% SAMPLING

Projects Approved by DFAB
Ineligible Under Existing IDB Regulations*

Project Name	City/County	Jobs Created/ Retained	Total Investment	DFAB Participation
1) Manchester Manufacturing	Manchester/Adams	125	$ 877,000	$ 175,000
2) Armco	Middletown/Butler	510	50,000,000	2,500,000
3) Arrow Internat.- (Clinton Rd. Partnership)	Brooklyn/Cuyahoga	179	2,850,000	1,000,000
4) LXD	Beachwood/Cuyahoga	82	1,670,000	795,000
5) Adventure Investments	Delaware/Delaware	58	597,000	245,000
6) B&D Plastics	Byesville/Guernsey	512	2,700,000	1,000,000
7) Greenfield Foods	Greenfield/Highland	300	6,000,000	2,500,000
8) Carborundum Grinding Wheel Company	Falls Twp./Hocking	100	1,900,000	755,000
9) Schneller,Inc.	Kent/Portage	83	6,250,000	1,100,000
0) N. American Philips Consumer Electronics	Ottawa/Putnam	1937	6,775,000	2,500,000
1) Advanced Turbo Manufacturing	Youngstown/Trumbull	650	10,000,000	5,000,000
2) Thermatex	Newton Falls/ Trumbull	146	1,610,000	400,000
3) GBKS (Gradall)	New Philadelphia/ Tuscarawas	523	9,230,000	2,160,000
TOTALS		5205*	$100,459,000*	$20,130,000*

* NOTE: Based on sampling of $50% of total projects funded since January, 1983.

STATEMENT OF LOUIS J. GAMBACCINI, ASSISTANT EXECUTIVE DIRECTOR/DIRECTOR OF ADMINISTRATION, THE PORT AUTHORITY OF NEW YORK AND NEW JERSEY, ALSO ON BEHALF OF DALLAS AREA RAPID TRANSIT, NEW JERSEY TRANSIT CORPORATION, SOUTHEASTERN PENNSYLVANIA TRANSPORTATION AUTHORITY, AND TRI-COUNTY METROPOLITAN TRANSPORTATION DISTRICT OF OREGON

Mr. Chairman and members of the Committee, thank you for the opportunity to submit written testimony for your consideration during deliberations on the Technical Corrections Act, HR 1800. This testimony is being submitted on behalf of the Port Authority of New York and New Jersey, New Jersey Transit, Dallas Area Rapid Transit, Southeastern Pennsylvania Transportation Authority and Portland's Tri-County Metropolitan Transportation District of Oregon (Tri-Met).

Last year, in the Deficit Reduction Act Conference Report, the House Ways and Means Committee included language allowing employers to provide employees with a *de minimis* fringe benefit of $15 per month for commutation by public transit. This testimony will focus on the need to broaden the Deficit Reduction Act of 1984 Report text in two ways: permit employers to assist employees with the actual cost of commuting by public transit; and clarify the administrative format, which could be interpreted to limit the benefit to the distribution of discounted passes or tokens, to include other mechanisms such as vouchers or reimbursements.

Our reasons for recommending changes to the current description of the public transit fringe benefit follow. We believe that they are consistent with the Committee's original intent to assist us in reducing automobile congestion during peak commuting hours and in maximizing transit ridership by involving businesses in prompting public transit.

Transit in our regions serves over one-third of the nations' public transit commuters. The New York/New Jersey Metropolitan Region alone accounts for nearly half of the country's annual miles of public transit travel. New Jersey Transit (NJ Transit) operates 380 route miles of commuter rail, 4.1 miles of light rail and 1800 buses to carry an average weekday patronage of over 100,000 people into the New York Metropolitan area. The Port Authority operates all the transportation facilities between New Jersey and New York across the Hudson River with the exception of the Amtrak line into Pennsylvania Station. Its interstate rapid transit service, PATH, carries about 200,000 daily riders primarily into Manhattan from New Jersey. The Dallas Area Rapid Transit (DART) operates 764 buses serving a daily patronage of 176,000 passengers. Portland, Oregon's Tri-Met serves 124,000 daily passengers on its 625 buses. In addition, Tri-Met will open its new 18 mile light rail line in 1986 which is designed to carry 40,000 people a day. SEPTA (Southeastern Pennsylvania Transportation Authority) serves the Philadelphia metropolitan area. Their services transport almost 1 million daily passengers on buses, trolley, subway, elevated lines and commuter rail lines. SEPTA operates over 2,500 vehicles on 150 routes covering 3,900 route miles.

EQUITY

All of the urban areas served by our agencies experience auto congestion during the peak commuting hours. We have all been attempting to provide attractive alternatives to commuting by autos. However, many autoists are provided financial incentives by employers for commuting by auto. Last year, the Port Authority conducted in depth surveys of all autoists using its three main vehicular facilities from New Jersey into Manhattan across the Hudson River. The surveys revealed that 64 percent of the daily auto commuters who travel into the Central Business District of Manhattan receive full or partial employer subsidies. In fact, more than 2 out of every 10 of these auto commuters are fully subsidized. The total values of these auto subsidies can be worth as much as $600 per month to commuters. For those receiving a partial subsidy, free parking is most common. Over half (54%) of these auto commuters receive subsidized parking in Manhattan where monthly parking costs run as high as $200 in the downtown area and $300 in the midtown area.

Alternatively, public transit expenses in certain regions like the New York area, are substantially less than auto commuting costs (including parking). Thus, the relative impact of the $15 transit benefit is far less than that available to autoists. New York subway riders pay $36 a month to commute, while suburban commuters or those living in the boroughs other than Manhattan using express buses, pay an average of $100 per month. Nationally, the average monthly cost of commuting by public transit is less than $50 excluding suburban commuter rail and express bus systems. Overall, the average monthly cost is less than $75 per month. In order to offset the disparity between auto-related employer provided fringe benefits and the present public transit fringe benefit, we believe that raising the benefit to the

actual cost of commuting by transit would establish a reasonable parity between auto and transit employer provided benefits.

MARKETING

Clarify administrative procedures

NJ Transit along with the Port Authority and the MTA have begun to develop program options to offer the public transit benefit to employers in the New York Metropolitan area. However, the diversity of public transit services in this region and the different fare systems employed by each agency creates a potentially burdensome situation for employers. For example, the MTA subways employ tokens, and buses accept tokens or cash; the surburban railroads operated by the LIRR, Metro-North, and NJ Transit Rail Corporation use different types of monthly passes and multi-ride tickets; and the Port Authority's PATH system accepts only cash. Therefore, limiting employers to the distribution of reduced cost passes and tokens will dictate a major administrative and financial effort requiring employers to work with at least four separate agencies to arrange for the monthly delivery of tokens and an assortment of passes. Furthermore, users of PATH and numerous private bus services would be totally excluded from the benefits of this program since no passes or tokens are available.

Considering that the public transit fringe benefit is a *de minimis* benefit, employers and transit agencies require more flexible administrative procedures to allow for the development of program options which minimize the administrative burden on employers. The proposed changes will fulfill these requirements. Where sale of discounted passes or tokens are practicable, the local transit authority will furnish employers with these tickets or tokens for redistribution on a discounted basis, and will recommend procedures against transferability. Where variable cost tickets or non-ticketed services are involved, it is clearly not feasible to rely on selling discounted tickets to employers. Instead, a system is being devised under which the employee can be reimbursed upon proof of purchaser of the ticket or usage of the service. As an alternative, consideration is also being given to developing a voucher for distribution to employees which can be redeemed at the time an employee purchases a commutation ticket.

Increase fringe benefit

Our other transit agencies, DART, Tri-Met and SEPTA, are able to offer discounted passes or tokens as the main means to provide the new public transit fringe benefit. But the size of the benefit compared with auto-related fringe benefits being offered reduces the attractiveness of public transit for those commuters who are able to use either mode. Current employer pass programs being marketed by these three agencies would be enhanced by allowing employers to assist employees with the actual cost of commuting by public transit and on a par with auto-related benefits. As indicated earlier, suburban commuters often pay $100 or more each month to commute by public transit. Increasing the benefit to cover these actual costs will provide an important incencitive to autoists to switch to transit and help retain existing transit ridership.

PRIVATE PARTICIPATION

Transit agencies such as ours are working to involve the private sector in meeting the transportation needs of urban areas. Given the limited capacity of existing roads to accommodate the number of employees who work in urban areas, our transit systems provide a critical link in the regional transportation network. The new fringe benefit allows us to involve employers in the support and promotion of public transit, as an important and realistic alternative to auto commuting. Furthermore, given the present threat of reduced federal operating assistance, increasing the benefit to the actual cost of commuting will provide transit agencies with the ability to obtain private funding to offset some of the effects of federal assistance reductions. Additionally, the employer program supports Congress' and the Administration's desire to encourage private participation in such public endeavors as mass transit.

Our recommended language to increase the *de minimis* employer transit fringe benefit and allow for vouchers and reimbursements will provide greater equity for transit users, enhance transit marketing and increase employer involvement in transit.

At a time when the country needs to optimize its public investment, it is critical that we enhance the efficiency and productivity of our transportation systems. In urban areas, increased transit usage as opposed to increased auto usage will maximize that investment.

Therefore, we strongly urge you to adopt our recommendations. Thank you again for the opportunity to submit testimony.

STATEMENT OF PPG INDUSTRIES, INC., BY STEWART & STEWART, COUNSEL

SUMMARY

The United States and Mexico recently concluded an agreement under which no countervailing duties will be levied on imports of Mexican goods into the United States unless it is proven that the imports are injuring or threatening to injure the domestic industry materially. Imports of automotive glass from Mexico are currently subject to a countervailing duty order, but otherwise enter duty-free under the GSP program. As Mexico is not a member of the GATT, it has not been entitled to rights held by full GATT members. Thus, no injury test was required by the U.S. government when the CVD petitions on a large number of duty-free articles were investigated. Two Mexican producers of automotive glass have requested that the Department of Commerce revoke the outstanding CVD order, on the alleged grounds that, as a result of the agreement, no duty can be levied on otherwise duty-free products unless and until injury has been proven.

Neither the language nor the background of the U.S.-Mexico agreement indicates that it is intended to apply to *outstanding* countervailing duty orders. To give the agreement retroactive effect would grant Mexico greater rights than those accorded countries which acceded to the Subsidies Code promptly—in short, would *reward* Mexico for failing to conclude a subsidy agreement with the U.S. for five years. Retroactive application would eliminate relief from the proven unfair trade practices, would require domestic industries to prepare and file new petitions, and would force the Department of Commerce to use its limited resources to repeat investigations it had already concluded, so violating the congressional intent that the countervailing duty procedure be made faster and more efficient. For these reasons, a technical amendment to H.R. 1800, to clarify that agreements such as that between the United States and Mexico are to have prospective effect only, is desirable.

STATEMENT

Introduction

Domestic industries are concerned that Congress' intentions with respect to existing countervailing duty orders will not be carried out by the U.S. Department of Commerce and International Trade Commission. Although the countervailing duty statute provides precise guidelines for application of the injury test in the context of *ongoing* investigations involving countries which only recently became "countries under the Agreement", an alleged lack of precision in the statutory language may result in elimination of *existing* countervailing duty orders.

Specifically, section 303(a)(2) of the Tariff Act of 1930 ("the Act"), as amended by the Trade Agreements Act of 1979, requires an injury test for countries not signatories of the Subsidies Code prior to imposition of countervailing duties where (1) the merchandise imported is free of duty and (2) international obligations of the United States require the injury test. 19 U.S.C. § 1303(a)(2). Section 303(a)(2) of the Act states as follows:

In the case of any imported article of merchandise which is free of duty, duties may be imposed under this section only if there are affirmative determinations by the Commission under subtitle IV of this chapter; except that such a determination shall not be required unless a determination of injury is required by the international obligations of the United States. (19 U.S.C. § 1303(a)(2)).

In a past decision by the U.S. Commerce Department involving industrial fasteners from India, a countervailing duty order was revoked because India was as GATT-signatory, certain fasteners were afforded duty-free entry under the Generalized System of Preferences (GSP) after the countervailing duty order was issued, and no injury determination had been made by the International Trade Commission. *Certain Fasteners From India,* 47 Fed. Reg. 44,192 (1982). On the basis of the *Fasteners* decision and because no injury test was ever applied, two Mexican producers of automotive glass have recently requested revocation of an outstanding countervailing duty order. PPG, the petitioner in the automotive glass case, would in the event of revocation have to refile its countervailing duty petition and undertake an entirely new investigation, needless to say, at great expense to the company and great duplication of effort by the government, while losing the protection from subsidized foreign competition in the interim.

Although the *Fasteners* case is easily distinguished from the Mexican one (Mexico is *not* a GATT-signatory and the Mexican merchandise was duty-free at the time of the original investigation), PPG nonetheless is concerned that section 303(a)(2) of the Tariff Act of 1930, as amended, could be misinterpreted to permit revocation of an existing countervailing duty order on the grounds that a retroactive injury test was not conducted. As outlined below, such a result, although inconsistent with normal rules of statutory construction and the apparent intent of Congress, has been requested in at least one administrative proceeding and would dictate the outcome of a large number of similar cases. For this reason, PPG respectfully requests that this Committee consider a technical amendment either to section 611 of the Trade and Tariff Act of 1984, or to section 303 of the 1930 Act, that would clarify the grounds for revocation of outstanding countervailing duty orders not intended to be afforded a retroactive injury test.

The Indian fasteners case

A countervailing duty order was issued against *Certain Fasteners from India* on July 21, 1980. 45 Fed. Reg. 48,607 (1980). At that time, India was not a "country under the Agreement," although it was a signatory to the General Agreement on Tariffs and Trade (GATT).[1] The merchandise itself was at that time dutiable merchandise subject to section 303 of the 1930 Act, although it had formerly been duty-free. In September 1981, the United States recognized India as a "country under the Agreement" as a result of a bilateral agreement between the two nations. *See* 47 Fed. Reg. 29,695 (Appendix 1). Thereafter, on January 6, 1982, certain of the industrial fasteners covered by the countervailing duty order were granted a return to their former duty-free treatment under the Generalized System of Preferences. *Id.;* 47 Fed. Reg. 31,305. And, on January 28, 1982, the Government of India requested that the International Trade Commission ("ITC" or "Commission") conduct an injury investigation, pursuant to the requirements of § 303(a)(2) of the Act. *Id.*

The Commission, by letter dated March 16, 1982, denied India an injury test based upon its reading of section 104(b) of the Trade Agreements Act of 1979 and section 751(b) of the Tariff Act of 1930. *See* 47 Fed. Reg. 29,695 (Appendix 1). Analyzing the literal language of the statute, the ITC viewed itself as lacking authority under section 104(b) to conduct an injury investigation with respect to a countervailing duty order issued after January 1, 1980. *See* 19 U.S.C. § 1671 (note). Furthermore, since section 751(b) of the Tariff Act of 1930 permits only a *review* of whether injury continues to exist, the ITC found that section 751(b) did not authorize an initial injury investigation. *See* Letter to N. Dayal, Minister, Commerce and Supply, Embassy of India, from Secretary, International Trade Commission, dated March 16, 1982 (Appendix 2).

Failing in its effort to get an injury investigation, India requested that the Department of Commerce revoke the countervailing duty order completely, on the ground that certain industrial fasteners were now duty-free and countervailing duties, under section 303(a)(2) of the Act, could not be imposed absent an injury investigation. Commerce acceded to the request, interpreting section 303(a)(2) to require an injury test and reasoning that since an injury test was impossible under the Commission's interpretation of sections 104(b) and 751(b), the countervailing duty order must be revoked.

By statute, the Department is authorized to impose countervailing duties on duty-free products from GATT member countries only if the International Trade Commission has found that imports of the merchandise materially injure, or threaten to materially injure, a United States industry. There has been no such determination with respect to duty-free fasteners from India covered by this order. As a result, the Department is revoking the countervailing duty order on certain fasteners from India with regard to covered duty-free fasteners. This revocation applies to all such duty-free fasteners entered on or after January 6, 1982, the date upon which these fasteners became duty-free. (47 Fed. Reg. at 44,129 (Appendix 1)).

Thus, in the unique context of a country that was a GATT-signatory and of merchandise that was afforded duty-free treatment several years after imposition of a countervailing duty order under section 303, the intersection of sections 303(a)(2)

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[1] A "country under the Agreement" is defined in section 701(b) of the Tariff Act of 1930 to be (1) a country which has adopted the "Agreement on Subsidies and Countervailing Duties" (hereafter "Subsidies Code"), (2) a country which has assumed "substantially equivalent" obligations with respect to the United States, or (3) a country with which the United States had an agreement prior to June 19, 1979, requiring unconditional most-favored-nation treatment, and not expressly permitting restrictions on imports to prevent unfair trade actions (*e.g.*, countervailing duty investigations). 19 U.S.C. § 1671(b).

and 751(b), as interpreted by the Commerce Department and ITC, caused an anomalous result: the countervailing duty order was revoked.

The Automotive Glass case

PPG Industries filed a countervailing duty petition against automotive glass from Mexico on July 31, 1984, and a countervailing duty order was issued on January 14, 1985. 50 Fed. Reg. 1,906 (1985). At the time of filing of the petition, and throughout the investigation, Mexico was neither a GATT signatory nor a "country under the Agreement" entitled to an injury test. Since before the date of filing of the petition, automotive glass from Mexico has been entitled to duty-free treatment under the GSP.

On April 23, 1985, the United States and Mexico concluded an "Understanding Between the United States and Mexico Regarding Subsidies and Countervailing Duties," as a result of which the United States agreed henceforth to consider Mexico a "country under the Agreement" as defined in section 701 of the Act. *Determination Regarding the Application of Certain International Agreements,* 50 Fed. Reg. 18,335 (1985) (Appendix 3). On the basis of the "Understanding" and the fact that automotive glass is entitled to duty-free entry under the Generalized System of Preferences, two Mexican producers of automotive glass requested revocation of the countervailing duty order, citing the *Fasteners* case.

Because Mexico is not and was not a GATT-signatory during the original countervailing duty investigation under section 303, because the "Understanding" on its face does not indicate it is to be applied retroactively, and because duty-free status has existed throughout the investigation, this action is distinguishable from the *Fasteners* situation.[2] However, an over-literal reading of section 303(a)(2), as advocated by the respondents in the automotive glass case, could result in revocation of an existing countervailing duty order on the theory that countervailing duties may not be imposed unless Mexico is given a retroactive injury investigation.

PPG submits that Congress never intended that countervailing duty orders would be revoked, or even that injury investigations would be provided retroactively, as a result of bilateral agreements that did not expressly provide for such revocation. Thus, a technical amendment to section 303(a)(2) of the Tariff Act of 1930 or to section 611 of the Trade and Tariff Act of 1984 is necessary to clarify Congress' intent. The amendment proposed will ensure that domestic industries are spared the absurd and excessive burden of having otherwise valid countervailing duty orders revoked due to the fact that, sometime after the order is issued, the country involved finally assumes obligations equivalent to the Subsidies Code.

New signatories were intended to receive prospective application of the injury test

A review of the statutory language and related legislative history makes clear that the purpose of the law was to encourage non-signatories of the Subsidies Code either to sign that code or to assume equivalent obligations toward the United States. It was never intended, however, that once a particular country signed such an agreement, the injury test would be provided retroactively in all existing countervailing duty cases. Rather, Congress limited the injury test to countervailing duty investigations *in progress* and future investigations.

Section 102 of the Trade Agreements Act of 1979 provides that where a countervailing duty investigation has been commenced under section 303, *but not yet finalized,* the investigation will be terminated as soon as Title VII becomes applicable. 19 U.S.C. § 1671 (note); *see Lamb Meat from New Zealand,* 46 Fed. Reg. 47,106 (1981). That is, where a foreign nation is not a "country under the Agreement" at the commencement of a countervailing duty action under section 303, but that country prior to a final determination does sign the Agreement (or its equivalent), then the section 303 investigation is terminated and a new investigation is commenced under Title VII (including an injury investigation).

The 1979 Act provided the injury test to all signatories with respect to future cases (sections 701, 703, 704, and 705) as well as any countervailing duty orders outstanding as of January 1, 1980, so long as an injury investigation was requested within three years (section 104(b) of the 1979 Act). Thus, countries which in 1979 had not signed the Code could thereafter come "under the Agreement" and then be provided an injury test—*with respect to ongoing cases (section 102) and outstanding*

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[2] On May 9, 1985, the Commerce Department published a tentative determination to revoke the countervailing duty order issued in *Carbon Steel Wire Rod from Trinidad and Tobago* on grounds virtually identical to those in *Industrial Fasteners from India.* 50 Fed. Reg. 19,561-62 (1985); *see* Letter to Deputy Assistant Secretary for Import Administration from Secretary, U.S. International Trade Commission, dated February 11, 1985 (Appendix 4).

orders entered prior to January 1, 1980 (section 104(b)). During the pendency of the ITC injury investigation, however, the outstanding countervailing duty order would remain in place.

Congress provided the injury test to signatories of the Subsidies Code, or its equivalent, only as the result of multilateral negotiations and *only* where specifically required to do so. Prior to 1974, the injury test was not provided in any countervailing duty investigations, and between 1974 and 1979 it was only provided to duty-free merchandise where U.S. international obligations *required* an injury test. Trade Act of 1974 § 331, Pub. L. 93–618; *see* S. Rep. No. 1298, 93d Cong., 2d Sess. 185 (1974); H.R. Rep. No. 317, 96th Cong., 1st Sess. 45 (1979). The Trade Agreements Act of 1979 provided for an injury test in countervailing duty cases (involving dutiable merchandise) as a *quid pro quo* for concessions by the United States' trading partners involving export subsidies, standards, government procurement, and so forth.[3]

Understood in this context, and in view of the express provisions of sections 102 and 104(b) of the 1979 Act, it is clear that Congress did not intend a sweeping application of the injury test to every existing countervailing duty order covering subsidized merchandise from non-GATT signatories. In fact, in the context of the recently enacted United States-Israel Free Trade Area, the House Ways and Means Committee made clear that the injury test would be applied only "prospectively, not to existing countervailing duty orders." H.R. Rep. No. 64, 99th Cong., 1st Sess. 8 (1985).[4]

An absurd result

Two possible scenarios are covered by the provisions just reviewed: (1) a non-signatory country is involved in an ongoing countervailing duty investigation but signs the Code (or an equivalent obligation) *before* the countervailing duty proceeding is complete and, under section 102, is afforded an injury test, or (2) a non-signatory is subject to a countervailing duty order published *before* January 1, 1980, but signs the Code *after* the order is issued and, under section 104(b), is afforded an injury test. In both cases, the domestic industry potentially injured by the unfairly traded imports is protected during the injury investigation by either suspension of liquidation, in the first scenario, or an outstanding countervailing duty order, in the second.

There is, however, a third possible situation: that a non-signatory might be subject to a countervailing duty investigation resulting in an order published *after* January 1, 1980, but does not sign the Code or its equivalent until *after* a countervailing duty order is issued. In that event, section 102 would not by its terms apply, since the order would already have issued. Nor would section 104(b) apply, since the order issued after January 1, 1980. This is precisely the situation which confronts PPG and the U.S. automotive glass industry with respect to Mexican imports of automotive glass.

The Mexican producers of automotive glass, asserting the applicability of the *Fasteners* decision, urge that Commerce should *revoke* the countervailing duty order applicable to Mexican automotive glass on the ground that no injury test has been provided under sections 102 or 104(b) of the 1979 Act or under section 751(b) of the Tariff Act of 1930. Under this theory, although Mexico did not sign the bilateral agreement during the pendency of the countervailing duty investigation, *by waiting until that investigation was over, Mexico could be rewarded by revocation of the existing countervailing duty order.* Having failed to sign an agreement until April 23, 1985, Mexico is now alleging its entitlement to a complete revocation of the countervailing duty order. Such a result would afford Mexico greater freedom to continue subsidized imports until a new case is initiated than countries which signed the Code promptly before 1980 or countries which hurried to sign the Code before completion of ongoing countervailing duty proceedings.

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[3] "The key concession by the United States in these negotiations is to include an injury test in our domestic legislation, something our trading partners have sought for many years." *Hearings before the Subcomm. on Trade of the House Comm. on Ways and Means,* 96th Cong., 1st Sess., Serial 96–13 at 501 (1979) (Statement of Alonzo L. McDonald, Deputy Special Representative for Trade Negotiations). "Although the caucus would have preferred that no material injury test be inserted into our countervailing duty statute, it recognizes that the acceptance of this additional test was the result of the bargaining process at the trade talks." Cong. Rec. H5583 (daily ed. July 10, 1979) (remarks of Representative Gaydos, Chairman of the Steel Caucus).

[4] Israel was already a GATT-signatory and, therefore, was already entitled to an injury test on imports of duty-free merchandise. 19 U.S.C. § 1303(a)(2). Congress made clear, however, that imports of merchandise under the provisions of the U.S.-Israeli Free Trade Agreement would only be given an injury test *prospectively.*

Introduction of the injury test in U.S. countervailing duty law, as reviewed above, was not intended to afford the injury test to all importing nations or to eliminate existing protection from unfairly subsidized imports during the pendency of an injury investigation. In fact, in sections 102 and 104(b) of the 1979 Act, Congress carefully preserved at least the suspension of liquidation on subsidized imports during the injury proceedings. Thus, revocation of an outstanding countervailing duty order because in a particular case neither sections 102, 104(b), nor 751(b) permits an injury test thwarts entirely the congressional intent.

The Trade and Tariff Act of 1984 provides expressly that foreign applicants for revocation of countervailing duty orders must bear the burden of persuasion with respect to whether changed circumstances justify revocation. Trade and Tariff Act of 1984, § 611(a)(2)(B)(iii), Pub. L. 98–573 (October 20, 1984). Congress also provided that no countervailing duty order is to be revoked under section 751 of the Tariff Act of 1930 on the grounds that the subsidizing government is offsetting the subsidy by levying export taxes. *Id.* § 611(a)(3). Together these recent enactments reflect Congress' reticence to revoke countervailing duty orders.

Furthermore, should the countervailing duty order covering Mexican automotive glass be revoked, PPG and the other domestic producers, rather than facing an injury investigation by the ITC, would instead have to file new countervailing duty petitions and prosecute a preliminary injury determination, preliminary and final ITA determinations, and a final injury determination before a countervailing duty order would be reinstated. Not only is this anomaly time-consuming and expensive, but it is also a needless waste of administrative manpower and attention to perform an essentially identical investigation. And, ironically, congressional concern that these investigations would be streamlined and expedited was a primary rationale for the 1979 Act. *See* H.R. Rep. No. 317, *supra,* at 24.

Distinctions between the Mexican and Indian cases

The primary distinction between the case of automotive glass from Mexico and that of industrial fasteners from India, or wire rod from Trinidad and Tobago, is that Mexico is not and was not a GATT-signatory prior to the date on which automotive glass became entitled to duty-free entry as GSP merchandise. In contrast, both India and Trinidad and Tobago were GATT-signatories, but were denied an injury test because the imported merchandise was dutiable merchandise, only later made duty-free.

Automotive glass from Mexico has been duty-free under the GSP since well before Mexico entered the bilateral agreement. Unlike India and Trinidad and Tobago, Mexico has never signed the GATT, but entered a bilateral agreement with the United States that does not by its terms afford an injury test retroactively. *See* Appendix 3. Thus, the situation with respect to automotive glass from Mexico may readily be distinguished from the other two cases.

Section 303(a)(2) does not require an injury test "unless a determination of injury is required by the international obligations of the United States." 19 U.S.C. § 1303(a)(2). The "international obligation" Congress specifically had in mind was Article VI of the GATT: "The United States is obligated to apply the injury test under section 303 only with respect to duty-free products of countries *which have fully acceded to the General Agreement on Tariffs and Trade.*" S. Rep. No. 249, *supra* at 103 (emphasis added); *see also* S. Rep. No. 1298, *supra* at 185. Accordingly, when India, a GATT-signatory, was denied an injury test on duty-free merchandise, Commerce believed itself obligated to revoke the antidumping duty order as unenforceable under section 303(a)(2).

Mexico, on the other hand, was not a GATT-signatory at the time the countervailing duty order on automotive glass was published, and it still is not a GATT-signatory. It had and has, therefore, no right under section 303(a)(2) to application of an injury test unless and until such a right is otherwise afforded by legislation or agreement. Given that the bilateral agreement between Mexico and the United States did not expressly provide for a retroactive injury test, this is a critical distinction vis-a-vis the application of section 303(a)(2).

Clarification of the ITA's authority to revoke outstanding orders is necessary

In light of the allegations made by Mexican respondents and the potential wide-ranging effects on U.S. commerce that would result from adoption of such views, PPG submits that Congress should act quickly to eliminate any possibility of confusion as to how the statute is to be applied to present and future bilateral agreements that impose obligations equivalent to signing the Subsidies Code. Revocation of existing countervailing duty orders places an unnecessary and overburdensome requirement on domestic industries that must suffer the effects of unfairly subsi-

dized imports and essentially rewards countries for delaying the assumption of subsidy commitments.

Accordingly, set forth below are two, alternate proposed revisions to the current countervailing duty laws that would eliminate the danger of revocation of existing countervailing duty orders for reasons other than the fact that subsidies are no longer being bestowed. PPG urges the Congress to adopt one of these proposals in order to clarify for the administration and the domestic industry the permissible use of revocation and the Congress' intent in providing an injury test applicable to merchandise from countries "under the Agreement."

Proposed changes

To remove any doubt that Congress intended to provide unconditionally for the retroactive imposition of an injury test on outstanding countervailing duty orders, the following technical amendment to §303(a)(2) of the Tariff Act of 1930, 19 U.S.C. § 1303(a)(2), is proposed (the underscored language shows additions to existing statute):

(2) In the case of any imported article or merchandise which is free of duty, duties may be imposed under this section only if there are affirmative determinations by the Commission under subtitle IV of this chapter; except that such a determination shall not be required *retroactively and shall not be required* unless a determination of injury is required unless a determination of injury is required by the international obligations of the United States.

Alternatively, the authority of the Commerce Department to revoke outstanding countervailing duty orders pursuant to section 303(a)(2) could be circumscribed by the following technical amendment to section 611(a)(2)(B) of the Trade and Tariff Act of 1984 (the underscored language shows additions to existing statute):

(b) REVIEWS UPON INFORMATION OR REQUEST.—

(1) IN GENERAL.—Whenever the administering authority or the Commission receives information concerning, or a request for the review of, an agreement accepted under section 704 (other than a quantitative restriction agreement described in subsection (a)(2) or (c)(3)) or 734 (other than a quantitative restriction agreement described in subsection (a)(2)) or an affirmative determination made under section 704(h)(2), 705(a), 705(b), 734(h)(2), 735(a), 735(b), 762(a)(1), or 762(a)(2), *but not an affirmative determination or order under § 303 of this Act,* which shows changed circumstances sufficient to warrant a review of such determinations, it shall conduct such a review after publishing notice of the review in the Federal Register. In reviewing its determination under section 704(h)(2) or 734(h)(2), the Commission shall consider whether, in the light of changed circumstances, an agreement accepted under section 704(c) or 734(c) continues to eliminate completely the injurious effects of imports of the merchandise. During an investigation by the Commission, the party seeking revocation of an antidumping order shall have the burden of persuasion with respect to whether there are changed circumstances sufficient to warrant revocation of the antidumping order.

Conclusion

Either of the proposals above would eliminate the absurd consequences that will flow from revocation of existing countervailing duty orders in the wake of new countries signing the Subsidies Code or adopting equivalent obligations. Domestic producers will not be exposed to subsidized imports, already determined to deserve a countervailing duty, and to the expense and delay involved in prosecuting a new countervailing duty investigation. For these reasons, PPG respectfully requests that the House Committee on Ways and Means add an appropriate amendment as a part of the Technical Corrections Act of 1985.

STATEMENT OF RALPH E. PURVIS, SILVERDALE, WA

My name is Ralph E. Purvis. I represent myself as an individual investor.

A grievous wrong was inflicted upon me and other similarly situated, several years ago when Congress enacted the Interest Equalization Tax Act.

As a result of passage of that act the U.S. government in 1964 collected from me $115,736.38 as a retroactive penalty for legitimate purchases of foreign securities which I had consumated prior to the enactment of that regulatory tax and paid for without export of capital with which to make the purchases.

As applied to my situation, this retroactive tax was a violation of the Fifth Amendment to the U.S. Constitution. In effect, I was robbed by my own government.

I previously attempted to obtain relief by way of legislation, and the attached statement designated Exhibit A, was made by me to the Senate Finance Committee in 1971 and is a fairly concise summary of my case. That statement also contains the language of the legislative act which was proposed by Senator Warren G. Magnuson in 1967 and again in 1969. That amendment was passed by the Senate in 1967 and 1969 but was not approved in Conference committee.

At the time the act was approved by the Senate Finance committee it was chaired by Senator Russell Long. See U.S. Code Administrative News, 1967, Volume 1, paragraph 5, page 1454.

At the hearings on this proposal before the Finance Committee, a statement in writing in support of its enactment was made by Senator Spark Matsunaga, who was then a member of the House of Representatives. A copy of his statement is attached and designated as Exhibit C.

I would hope that Senators Long and Matsunaga will again support this corrective measure.

I am attaching a copy of a bill, Exhibit B, which I ask that you now enact. This bill is the same as that previously passed by the Senate. Enactment of this bill would correct this grievous error.

In all my previous attempts to secure legislative relief, the issue of the constitutionality of the retroactive application of the tax with respect to my state of facts was never raised.

After failing to secure legislative relief in 1969 I instituted legal action in Federal Court, challenging the constitutionality of the retroactive taxation of my transactions. I lost the case in District Court and appealed to the Ninth Circuit Court of Appeals. The Appeals Court affirmed the District Court in a split 2–1 decision. The dissenting opinion by Judge J. Clifford Wallace found the retroactive taxation of my transactions to be unconstitutional. A copy of that dissenting opinion is attached as Exhibit D.

I filed a petition for writ of certiorari to the Supreme Court, which was denied in 1975.

Having exhausted all legal remedies, I am now again attempting to obtain relief by way of legislation favorable to myself and all others in my category.

In spite of the lapse of time from date of payment of the tax, I submit this great wrong to myself, and others similarly situated, should now be rectified.

I would hope that the Congress will approve this proposed legislation.

STATEMENT OF EXHIBIT A

RALPH E. PURVIS, SILVERDALE, WASHINGTON

COMMITTEE ON FINANCE
U. S. SENATE

RE: Interest Equalization Tax
Extension Act - H.R.5432

My name is Ralph E. Purvis. I am from the State of Washington and am a member of the Bar of that State. I appear here representing myself as an individual investor.

The House passed bill to extend the Interest Equalization Tax, H.R.5432, contains several technical amendments. The reason given for these amendments is to "eliminate unintended hardships."

My purpose in submitting this statement is to eliminate a hardship which the Treasury Department and the House have overlooked. The substance of the hardship of which I speak was dealt with in S. 2438, introduced in 1969. Senator Warren Magnuson introduced an identical bill last week. The Magnuson Bill is identical to the proposal set forth below and identical to the proposal approved and passed by the Senate Finance Committee and the Senate as an amendment to the Interest Equalization Tax Extension Acts of 1967 and 1969. Although approved by the Senate, this amendment was not contained in the bill reported out of the Conference Committee either year.

My proposal would add a new subsection which would exempt from taxation purchases made during the initial retroactive period of July 18, 1963, to September 2, 1964, if and only if purchases of securities were made with funds held by United States taxpayers outside of the United States on July 18, 1963. In such instances, there was no export of capital from the United States, and the purpose of the Interest Equalization Tax - namely to prevent future outflows of capital after July 18, 1963 - was not violated.

The following is the text of the new subsection:

That (a) section 4914 of the Internal Revenue Code of 1954 (relating to exclusion for certain acquisitions) is amended by adding at the end thereof the following new subsection:

(k) certain acquisitions before September 2, 1964.--The tax imposed by section 4911 shall not apply to an acquisition made before September 2, 1964, by a United States person of stock or a debt obligation if such acquisition was made--

(1) from funds held by such person on July 18, 1963, and,

(2) from funds held by such person on July 18, 1963, which were on deposit outside the United States with persons carrying on the banking business, and,

(3) from the proceeds of the disposition of stock of foreign issuers, or debt obligations of foreign obligors, held by such person on July 18, 1963, and,

(4) from the proceeds of the disposition of stock of foreign issuers, or debt obligations of foreign obligors, acquired by such person after July 18, 1963, in an acquisition to which paragraph (3) applied, or

(5) from credit obtained in a foreign country.

(b) The amendment made by subsection (a) shall apply with respect to acquisitions of stock and debt obligations made after July 18, 1963.

Tax Impact

During the retroactive period many persons, like myself, who had funds invested in foreign securities for many years prior to July 18, 1963, continued to manage those investments by making sales and purchases, not knowing whether the Interest Equalization Tax would ever actually be enacted, what countries would be exempted, and what rates of tax would apply if it ultimately did become law. Since there was no actual prohibition of trading in foreign securities, and no tax actually enacted, as I say, many persons consummated purchase transactions prior to enactment and with funds located outside the United States prior to July 18, 1963.

Some persons in this category, like myself, no doubt assumed the tax would not apply in those instances where no capital was exported after July 18, 1963. Not until shortly after the act became law did they realize that such transactions were taxable not only in those instances where

capital was exported, but also in those instances where capital was not exported. I fit the second category.

For many years prior to July 18, 1963, I had funds in Canada and funds invested in Canadian securities, and had actively traded in listed stocks on Canadian exchanges. I was, of course, aware of President Kennedy's request that Congress enact this tax retroactively, but assumed it would not apply to my funds located outside the United States prior to July 18, 1963. As I understood it, the purpose of the Interest Equalization Tax was to curb the further transfer of capital, not to penalize those persons who had relied on existing law for many years.

As a consequence, I continued to manage my investment portfolio in Canadian securities during the retroactive period, and made some purchases during that period, but with funds located outside the United States prior to July 18, 1963. In other words, I did not export any capital, yet the tax was applied to the same extent as if there had been a direct transfer of capital.

Legislative History

President Kennedy in an effort to stem the further flow of capital to foreign countries, proposed the Interest Equalization Tax on July 18, 1963. Following more than a year of consideration, Congress enacted the tax on September 2, 1964. The tax on the purchase of foreign securities was

made retroactive to July 18, 1963, and applied to all purchases subsequent to that date. With regard to purchases within the retroactive period of 13 months the act makes no distinction between purchases financed with capital already located outside the United States prior to July 18, 1963, and purchases made with capital exported from the United States between July 18, 1963 and September 2, 1964.

I have carefully searched the record of the legislative hearings in connection with the original Interest Equalization Tax, and I am certain the impact on the retroactive feature with respect to instances of purchases made within that period, and with funds located outside the United States prior to the effective date, was never discussed or considered by any Committee of Congress.

The ostensible purpose of the tax, as expressed by President Kennedy when first suggested, and the act itself, was to prevent any further outflow of dollars after July 18, 1963.

Conclusion

I respectfully submit that there was both Executive and Congressional oversight of this matter when the legislation was first considered. I would hope that the Committee and the Congress would agree that unintended inequities have resulted and would see fit to adopt the suggested proposal set out above or a similar proposal to provide relief.

EXHIBIT B

S.B._____

IN THE SENATE OF THE UNITED STATES

Mr. introduced the following bill; which was referred to the Committee on _____

A BILL

To provide that the interest equalization tax heretofore levied upon foreign securities transactions, should not have been applied retroactively to certain stock acquisitions when no money moved from the United States for such purpose.

Be it enacted by the Senate and House of Representatives of the United Staets of America in Congress assembled,

Sec. 1. The tax heretofore imposed by section 4911 Public Law 88-564 78 Stat 809 88th Congress, 2nd Session, shall not apply to an acquisition made before September 2, 1964, by a United States person of Stock or a debt obligation if such acquisition was made -

"' (a) with foreign currency held by such person on July 18, 1963,

"' (b) from funds held by such person on July 18, 1963, which were on deposit outside the United States with persons carrying on the banking business,

"' (c) from the proceeds of the disposition of stock of foreign issuers, or debt obligations of foreign obligors, held by such person on July 18, 1963.

"' (d) from the proceeds of the disposition of stock of foreign issuers, or debt obligations of foreign obligors, acquired by such person after July 18, 1963, in an acquisition to which paragraph (c) applied, or

"' (e) from credit obtained in a foreign country.'"

Sec. 2. Any person who has paid a tax imposed by Section 4911, Public Law 88-563 78 Stat 809, 88th Congress, 2nd Session, on any transaction described in subsection (1) above shall be refunded taxes paid, plus interest from date of payment, by the Department of the Treasury.

If refund or credit of any overpayment of tax resulting from the application of section 1 is prevented by the operation of any law or rule of law on any day within 1 year after the date of the enactment of this Act, refund or credit of such overpayment (including interest, for the period beginning on the date which occurs 180 days after the date that a claim is filed and ending on the date that refund or credit is made of allowed, at the rate determined pursuant to section 6621 of the Internal Revenue Code of 1954) may, nevertheless, be made is allowed if claim therefor is filed within 1 year after such date.

EXHIBIT C

MATERIAL RECEIVED FOR THE RECORD

STATEMENT OF HON. SPARK M. MATSUNAGA, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF HAWAII

Mr. Chairman and members of the Committee, I thank you for this opportunity to testify with respect to H.R. 3813, the Interest Equalization Tax Extension Act of 1967.

My principal reason in entering this appearance is to suggest an amendment to the bill in order to rectify what appears to be an inadvertent injustice which resulted from the 1964 Act.

As you know, the existing law was first proposed on July 18, 1963, but enactment was not accomplished until September 2, 1964. At the time of enactment, the 15 per cent tax on the purchase of foreign securities was made retroactive to July 18, 1963 and therefore applied to all purchases subsequent to that date. This retroactivity covered a period of over thirteen months, but the Act contained no provision to distinguish, on the one hand, purchases financed with capital already located outside the United States prior to July 18, 1963, and, on the other hand, purchases made with capital exported from the United States between July 18, 1963 and September 2, 1964. In short, the tax was levied retroactively on purchases in both categories.

It is my understanding that the purpose of this legislation, as expressed by President Kennedy when it was first proposed, as well as by the Act itself, was to prevent any further outflow of dollars after July 18, 1963.

From representations made to me, I am convinced that prior to the actual passage of the Act, many American investors reasonably assumed that, in view of the stated purpose of the legislation, there would be an exemption of purchases consummated prior to its enactment with funds located outside the United States prior to July 18, 1963. These persons continued to buy and sell foreign securities up to the time of enactment. Thus, they unwittingly incurred tax liability even though they had not thereby caused any further outflow of U.S. dollars subse-

quent to July 18, 1963. They were taxed retroactively on these transactions as if they had actually exported capital. Conceivably, the Act exceeded its stated purpose and subjected many Americans to tax liability as the result of transactions which had caused no further outflow of dollars.

The amendment I am suggesting would exempt from the tax persons in this special category whose purchases during the thirteen-month period did not result in any further outflow of U.S. dollars. The offered amendment, if adopted and passed with the rest of the bill under consideration, would enable these persons to obtain a refund of taxes paid retroactively on such purchases. I have no idea as to the total number of taxpayers or the dollar amount involved, but in Hawaii alone there were about 10,000 investors holding approximately $20,000,000 in foreign securities when the 1964 law was enacted. Many of them were made victims of the circumstances.

The text of the proposed amendment follows:

"(a) section 4914 of the Internal Revenue Code of 1954 (relating to exclusion for certain acquisitions) is amended by adding at the end thereof the following new subsection:

"(k) CERTAIN ACQUISITIONS BEFORE SEPTEMBER 2, 1964—The tax imposed by section 4911 shall not apply to an acquisition of stock or a debt obligation made before September 2, 1964, by a United States person if such acquisition was made—

"(1) with foreign currency held by such person on July 18, 1963,

"(2) from funds held by such person on July 18, 1963, which were on deposit outside the United States with persons carrying on the banking business,

"(3) from the proceeds of the disposition of stock or foreign issuers, or debt obligations of foreign obligors, held by such person on July 18, 1963,

"(4) from the proceeds of the disposition of stock of foreign issuers, or debt obligations of foreign obligors, acquired by such person after July 18, 1963, in an acquisition to which paragraph (3) applied, or

"(5) from credit obtained in a foreign country.

"(b) The amendment made by subsection (a) shall apply with respect to acquisitions of stock and debt obligations made after July 18, 1963.

Mr. Chairman and members of the Committee, I strongly urge the adoption of this amendment to correct the unintended and unjust tax impact in the special limited situation to which the amendment would be applicable.

Thank you.

WALLACE, Circuit Judge, Dissenting:

I respectfully dissent.

The majority threads a delicate course in discussing case authority as it upholds the retroactive application of the Interest Equalization Tax Act of 1964. In doing so,

it brushes aside too lightly the obvious distinctions between the present case and the prior cases it cites which upheld retroactive taxation. The majority rejects the taxpayer's argument "that retroactivity can be sanctioned only if the tax is not imposed upon a voluntary act, or if the taxpayer is forewarned of retroactivity by the statute books themselves or by previous practices of Congress." The majority draws comfort from the Court of Claims which, when faced with the same issue as we have before us, found that the Supreme Court in *Welch v. Henry*, 305 U.S. 134 (1938), had not established such a "rigid standard of constitutionality" and upheld the tax. *First Nat'l. Bank v. United States*, 420 F.2d 725, 730 (Ct.Cl.), *cert. denied*, 398 U.S. 950 (1970). The correct test as established by the Supreme Court, the majority asserts, is "to consider the nature of the tax and the circumstances in which it is laid" before determining its constitutionality. The majority and the Court of Claims both ignore the fact that in *Welch*, the Court reaffirmed its prior holding declaring retroactive taxes unconstitutional where the taxpayer might well have refrained from the conduct creating the tax liability, "had he anticipated the tax. . . ." 305 U.S. a 147. In addition, the *Welch* Court distinguished *Coolidge v. Long*, 282 U.S. 582 (1931); *Untermyer v. Anderson*, 276 U.S. 440 (1928); and *Nichols v. Coolidge*, 274 U.S. 531 (1927), which held retroactive taxes unconstitutional, from the case before it on the ground that it could not assume that the taxpayer would have refused to receive the income even if he had known that it "would later be subject to a new tax or to the increase of an old one." 305 U.S. at 148. The tax upheld in *Welch* was an income tax on corporate dividends. Prior to the enactment of the tax this source of income had essentially been free from taxation. The law became effective in 1935 but imposed a tax upon income earned in 1933 and 1934. The law specifically declared "that the levy was an emergency tax to provide revenue for relief purposes. . . ." 305 U.S. at 142.

By comparison, the interest equalization tax is primarily regulatory. As the majority states, its purpose was "to restrict long term capital outflow from the United States by making it more expensive to borrow in the American

market." The raising of revenue was only an incidental benefit. Given this statement of purpose, the retroactive application of the tax cannot be justified on the ground that the taxpayer would have conducted his affairs exactly the same even if he had absolute knowledge the tax would be retroactively applied. From a realistic point of view, if the taxpayer were sure of taxation, he may well have not continued to invest in the foreign market since the tax was so substantial as practically to eliminate the likelihood of a profit.[1] Because of this, the retroactive application of the tax can be upheld only if the taxpayer had sufficient notice that his conduct would be subject to a regulatory tax.

The majority concludes that the taxpayer had ample notice because the President's request for the tax was well publicized and known generally among investors. In addition, the President had specifically requested that the tax be retroactive. Nevertheless, the majority slides over the fact that many Presidents have requested a great deal of legislation which has never seen the light of day; to do so, it rationalizes that Congress ratified the executive action when it made the tax retroactive, citing *United States v. Heinszen & Co.*, 206 U.S. 370 (1907), and *Mattingly v. District of Columbia*, 97 U.S. 687 (1878).

Ratification, however, is not involved in this case and the majority's authority is, therefore, of no assistance on

---

1. The tax imposed ranged from 15% to 22.5% of the value the foreign stocks acquired. The relevant language of the statute reads:

> (a) In general.—There is hereby imposed, on each acquisition by a United States person . . . of stock of a foreign issuer . . . a tax determined under subsection (b).
>
> (b) Amount of tax.—
>
> . (1) Rates of tax.—Except as provided in paragraphs (2) and (3)—
>
> (A) Stock.—The tax imposed by subsection (a) on the acquisition of stock shall be equal to 15 percent of the actual value of the stock.
>
> (3) Rates during interim period.—In thecase of acquisitions of stock . . . made after January 25, 1967, and before the thirtieth day after the date of the enactment of this paragraph, the tax imposed by subsection (a) shall be 22.5 percent in the case of acquisition of stock . . . .

23 U.S.C. § 4911.

the issue of adequate notice. In *Heinszen*. the Supreme Court articulated the principle of ratification as follows:

> That where an agent, without precedent authority, has exercised in the name of a principal a power which the principal had the capacity to bestow, the principal may ratify and affirm the unauthorized act, and thus retroactively give it validity when rights of third persons have not intervened, is so elementary as to need but statement. That the power of ratification as to matters within their authority may be exercised by Congress, state governments or municipal corporations, is also elementary. 206 U.S. at 382.

The *Heinszen* Court held that Congress had the power to ratify a system of tariff duties imposed by the President upon goods coming into the Philippine Islands. The Court stated that the President had imposed and collected the tariffs without authority but concluded that the action was valid because of the subsequent ratification by Congress. Similarly in *Mattingly*, the Court upheld assessments laid, without authority, by a board of public works where Congress subsequently ratified the action.

These cases would be persuasive authority in the present case if the President had actually levied and collected the interest equalization tax. But he did not take such drastic action; he merely requested Congress to enact the tax. This distinction is significant because of the effect the two different courses of conduct have upon the manner in which a taxpayer conducts his business affairs. Where the President takes action, even without authority, the effect is immediate and certain. The taxpayer is required either to alter his course of conduct or to pay the tax. If the President's action is subsequently ratified, the taxpayer has at least had the benefit of certainty in arranging his affairs. If the action is held to be illegal he can recover the tax he has paid.

On the other hand, where the President merely requests Congress to take action, regardless of how well publicized the request is, the effect is postponed and uncertain. The Congress may reject the request altogether or may modify it to the extent that it only faintly re-

sembles the President's original proposal. It would be harsh and arbitrary to expect a person to arrange his affairs on the basis of such a request. If he declines to invest because of a Presidential request for legislation which is not forthcoming, he has no conceivable remedy for the loss he may have suffered.

The present case is almost identical to *Untermyer v. Anderson*, 276 U.S. 440 (1928). The Revenue Act of 1924, 43 Stat. 313, imposed a tax on all gifts made any time during the calendar year of 1924, but did not become effective until June 2, 1924. Prior to its decision in *Untermyer*, the Court held the tax unconstitutional as applied to a gift made in January, 1924, on the ground that it was so arbitrary as to be a denial of due process. *Blodgett v. Holden*, 275 U.S. 142 (1927). In that case, the Court stated that "[i]t seems wholly unreasonable that one who, in entire good faith and without the slightest premonition of such consequence, made absolute disposition of his property by a gift should thereafter be required to pay a charge for so doing." 275 U.S. at 147. In *Untermyer*, the Court considered the constitutionality of the same tax as applied to a gift made on May 23, 1924, just 12 days before the Act was approved by the President. The government argued that as retroactively applied to this gift the tax was not unconstitutional because the taxpayer had ample notice of the proposed tax and, in all likelihood, had made the gift at that particular time to avoid tax liability. The government pointed out that the gift was made three months after the proposed tax had been presented and while the conference report was still pending. The Court rejected the argument, holding the retroactive application of the tax unconstitutional. The Court stated:

> The mere fact that a gift was made while the bill containing the questioned provisions was in the last state of progress through Congress we think is not enough to differentiate this cause from the former one and to relieve the legislation of the arbitrary character there ascribed to it. To accept the contrary view would produce insuperable difficulties touching interpretation and practical application of the statute, and render impossible proper understanding

> of the burden intended to be imposed. The taxpayer may justly demand to know when and how he becomes liable for taxes—he cannot foresee and ought not to be required to guess the outcome of pending measures. The future of every bill while before Congress is necessarily uncertain. The will of the lawmakers is not definitely expressed until final action thereon has been taken. 276 U.S. at 445-46.

The taxpayer in the present case, like the taxpayer in *Untermyer*, may have had ample notice of the proposed tax. But as the Court stated, he should not be required to guess on what the legislative outcome would be. This holding seems particularly appropriate in the present case because the taxpayer was required to guess the legislative outcome of the tax through the entire legislative process, whereas in *Untermyer* the tax had already passed both houses of Congress and awaited only the conference report, final congressional approval and the signature of the President.

I would hold the tax as applied to the transactions involved in this case unconstitutional.

STATEMENT OF HON. HARRY M. REID, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEVADA

Mr. Chairman, the Technical Corrections Act will impact most disastrously upon a sparsely populated, economically depressed county in the State of Nevada. That is White Pine County, authorized in 1979 to commence an economic development program in the form of a coal fired electric generation facility. The facility would not only bring electric power to rural Nevada and to metropolitan regions of Nevada and California, but would also provide thousands of temporary jobs during the project construction and hundreds of permanent jobs after the construction of the project. It would also provide nearly a half billion dollars over the project life in lieu of tax payments to the State of Nevada and its counties. The project is designed to bring as much as 300 mw of electric power to my district.

After 1979 state legislative authorization of this project, it went forward with its feasibility and environmental impact studies and has completed them. It has received the necessary water, air quality and right-of-way permits. It has also expended or committed for expenditure in excess of $20,000,000. These expenditures and commitments were made in reliance upon Section 103 of the Internal Revenue Code and the regulations thereunder. That is, certain nonexempt Nevada entities, including the utility which serves my district, were invited to participate to the allowable limit of 25%.

Now, however, I understand the Technical Corrections Act would limit the private or non-exempt participation to 5%. I am advised that this will more than likely cause the project's termination. I think this is particularly unfair inasmuch as the project has been proceeding forward for six years in good faith under Internal Revenue laws and rules upon which it should have been entitled to rely. I respectfully request that the project be "grandfathered" in some fashion so as to be immune from the limitations of the Technical Corrections Act of 1985 to the extent that it changes preexisting Internal Revenue Code Rules applicable to the project. The granting of such "grandfather" status is unlikely to result in a loss of tax revenue by the United States because without tax exempt financing it is almost certain the project will never be built.

Thank you for receiving my testimony in this matter.

Tax Research Institute of America
National Press Building Washington D.C.

COMMITTEE ON
RECEIVED
MAY 1 1985
WAYS AND MEANS

James M. Russell

April 25, 1985

Joseph K. Dowley
Chief Counsel, Committee on
Ways and Means
U.S. House of Representatives
1102 House Office Building
Washington, D.C. 20515

Re: H.R. 1800, Technical Corrections Act of 1985

Dear Mr. Dowley:

In connection with your forthcoming hearing on the above measure, we would like to submit for the record a needed additional technical correction we identified during our analysis of recent legislation for our tax publications.

Internal Revenue Code section 219(f)(1) defines compensation to include earned income as defined in section 401(c)(2) reduced by the deduction allowed under section 62(7). The section 62(7) deduction is that allowed for the individual under section 404.

Since earned income under section 401(c)(2) is after deductions allowed under section 404, the section 219(f)(1) directive to reduce earned income by the section 62(7) deduction seems wrong. It has already been reduced in section 401(c)(2).

The inconsistency arose when TEFRA amended section 401(c)(2) but not section 219(f)(1), and so would be a technical correction to TEFRA. H.R. 1800 now contains TEFRA technical corrections, including another arising from the section 401(c)(2) amendment.

A copy of the present section 219(f)(1) indicating the proposed correction is enclosed.

We appreciate the opportunity to make this suggestion.

Yours very truly,

James M. Russell

JMR:cdw
Enc.

(A) ... joint return under section 6013 for a taxable year, and

(B) ... spouse has no compensation (determined without regard to section 911) for such taxable year,

there may be allowed as a deduction any amount paid in cash for the taxable year by or on behalf of the individual to an individual retirement plan established for the benefit of his spouse.

(2) Limitation. The amount allowable as a deduction under paragraph (1) shall not exceed the excess of

(A) the lesser of

(i) $2,250, or

(ii) an amount equal to the compensation includible in the individual's gross income for the taxable year, over

(B) the amount allowable as a deduction under subsection (a) for the taxable year (determined without regard to so much of the employer contributions to a simplified employee pension as is allowable by reason of paragraph (2) of subsection (b)).

In no event shall the amount allowable as a deduction under paragraph (1) exceed $2,000.

(d) Other limitations and restrictions.

(1) **Beneficiary must be under age 70°s1/2.** No deduction shall be allowed under this section with respect to any qualified retirement contribution for the benefit of an individual if such individual has attained age 70°s1/2 before the close of such individual's taxable year for which the contribution was made.

(2) **Recontributed amounts.** No deduction shall be allowed under this section with respect to a rollover contribution described in section 402(a)(5), 402(a)(7), 403(a)(4), 403(b)(8), or 408(d)(3).

(3) **Amounts contributed under endowment contract.** In the case of an endowment contract described in section 408(b), no deduction shall be allowed under this section for that portion of the amounts paid under the contract for the taxable year which is properly allocable, under regulations prescribed by the Secretary, to the cost of life insurance.

(4) **Denial of deduction for amount contributed to inherited annuities or accounts.** No deduction shall be allowed under this section with respect to any amount paid to an inherited individual retirement account or individual retirement annuity (within the meaning of section 408(d)(3)(C)(ii)).

(e) Definition of retirement savings contributions, etc.

For purposes of this section

(1) **Qualified retirement contribution.** The term "qualified retirement contribution" means

(A) any qualified voluntary employee contribution paid in cash by the individual for the taxable year, and

(B) any amount paid in cash for the taxable year by or on behalf of such individual for his benefit to an individual retirement plan.

(2) **Qualified voluntary employee contribution.**

(A) In general. The term "qualified voluntary employee contribution" means any voluntary contribution

(i) which is made by an individual as an employee under a qualified employer plan or government plan, which plan allows an employee to make contributions which may be treated as qualified voluntary employee contributions under this section, and

(ii) with respect to which the individual has not designated such contribution as a contribution which should not be taken into account under this section.

(B) Voluntary contribution. For purposes of subparagraph (A), the term "voluntary contribution" means any contribution which is not a mandatory contribution (within the meaning of section 411(c)(2)(C)).

(C) Designation. For purposes of determining whether or not an individual has made a designation described in subparagraph (A)(ii) with respect to any contribution during any calendar year under a qualified employer plan or government plan, such individual shall be treated as having made such designation if he notifies the plan administrator of such plan, not later than the earlier of

(i) April 15 of the succeeding calendar year, or

(ii) the time prescribed by the plan administrator,

that the individual does not want such contribution taken into account under this section. Any designation or notification referred to in the preceding sentence shall be made in such manner as the Secretary shall by regulations prescribe and, after the last date on which such designation or notification may be made, shall be irrevocable for such taxable year.

(3) **Qualified employer plan.** The term "qualified employer plan" means—

(A) a plan described in section 401(a) which includes a trust exempt from tax under section 501(a),

(B) an annuity plan described in section 403(a), and

(C) a plan under which amounts are contributed by an individual's employer for an annuity contract described in section 403(b).

(4) **Government plan.** The term "government plan" means any plan, whether or not qualified, established and maintained for its employees by the United States, by a State or political subdivision thereof, or by an agency or instrumentality of any of the foregoing.

(5) **Payments for certain plans.** The term "amounts paid to an individual retirement plan" includes amounts paid for an individual retirement annuity or a retirement bond.

(f) Other definitions and special rules

• *Caution:* The last sentence of para. (f)(1), following, is effective for tax. yrs. begin. after 12/31/84.

(1) **Compensation.** For purposes of this section, the term "compensation" includes earned income (as defined in section 401(c)(2)), ~~reduced by any amount allowable as a deduction to the individual in computing adjusted gross income under paragraph (7) of section 62~~. The term "compensation" does not include any amount received as a pension or annuity and does not include any amount received as deferred compensation. The term "compensation" shall include any amount includible in the individual's gross income under section 71 with respect to a divorce or separation instrument described in subparagraph (A) of section 71(b)(2).

(2) **Married individuals.** The maximum deduction under subsections (b) and (c) shall be computed separately for each individual, and this section shall be applied without regard to any community property laws.

(3) **Time when contributions deemed made.**

• *Caution:* Subpara. (f)(3)(A), following, is effective for contributions made before 1/1/85. For subpara. (f)(3)(A) effective for contributions made after 12/31/84, see below.

(A) Individual retirement plans. For purposes of this section, a taxpayer shall be deemed to have made a contribution to an individual retirement plan on the last day of the preceding taxable year if the contribution is made on account of such taxable year and is

May 29, 1985

Joseph K. Dowley
Chief Counsel
Ways and Means Committee
U. S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Comments for Hearing on H.R. 1800 Technical Corrections Bill -- Impact of Section 7702(a) on Qualification of Self-Insured Plans as Life Insurance Under Section 101(a)

Dear Mr. Dowley:

The following comments are submitted for inclusion in the printed record of hearings to be held on May 16, 1985 by the Ways and Means Committee on H.R. 1800, proposing technical corrections to the 1984 Tax Reform Act.

The Risk and Insurance Management Society, Inc., commonly known as RIMS, is a non profit association representing corporate, governmental, and institutional self insurers and consumers of insurance in over 76 chapters throughout the United States and Canada. Our members, which include over 92% of the Fortune 500 Companies, account for the purchase of more than $35 billion of insurance and benefit services annually.

RIMS is deeply concerned that Section 7702(a) may unfairly discriminate against the employees of RIMS members receiving benefits under an employer funded life insurance plan.

Summary

Section 7702(a), if not clarified, could upset relatively well-settled law concerning the tax treatment of employer maintained life insurance plans. In this regard, the following points are relevant:

- The Section 101(a) exclusion from gross income for life insurance proceeds has typically been applied to self-insurance under prior law, where certain aspects of insurance are present.

- The aspects of insurance under the law for tax purposes are (1) risk shifting and risk distribution; (2) actuarial soundness; and (3) a binding obligation to pay.

- Prior law did not require contracting with an unrelated insurance company as a condition of qualification as insurance.

- There is no justification for imposing such a requirement under Section 7702(a), which was not intended to address this issue.

- As presently drafted, depending on the laws of each state, Section 7702(a) could be interpreted to deny qualification to employer maintained life insurance plans under Section 101(a), thus discriminating against self-insurers and providing an unfair advantage to commercial life insurance companies.

Proposal

We propose a clarification of Code Section 7702(a) with respect to the definition of a "life insurance contract", to clarify that Section 7702(a) was not intended to preclude the qualification of death benefits paid under a self-insured employer plan as "amounts received... under a life insurance contract" within the meaning of Section 101(a)(1). The following underlined portion is proposed as an amendment to Section 7702(a) to clarify its application to certain death benefits:

> (a) GENERAL RULE -- For purposes of this title, the term "life insurance contract" means any contract which is a life insurance contract under the applicable law, <u>without regard to any requirement under applicable law that such a contract be issued by an insurance company</u>, but only if such contract... .

The proposed technical correction would guarantee that Section 7702(a), which was intended to prevent investment-type contracts (<u>e.g.</u>, "universal life insurance") from qualifying for favorable tax status as life insurance, will not be interpreted to discriminate against self-insurers by requiring them to purchase coverage from a life insurance company to qualify under Section 101(a). This would permit an employer's decision

whether to self-insure an employee life insurance plan to continue to be made on a tax-neutral basis, and would avoid conferring an unfair advantage on life insurance companies.

Section 101(a)

Section 101(a)(1) provides in pertinent part as follows:

> [G]ross income does not include amounts received... under a life insurance contract, if such amounts are paid by reason of the death of the insured.

The term "life insurance contract" is not defined in Section 101(a) or the regulations thereunder. However, Treas. Reg. §1.101-1(a)(2) contains a number of cross references to other sections of the Code and regulations pertaining to life insurance contracts and insurance companies, including Sections 72(m)(3) and 801.

Section 72(m)(3) governs the tax treatment of life insurance contracts purchased by a qualified Section 401 and 403 plan. Treas. Reg. §172-2(a)(1), interpreting this provision, provides that it is immaterial whether a contract is entered into with an insurance company, for purposes of classification as a life insurance contract.

Section 801 defines the term "insurances company" as a company predominantly engaged in the issuing of insurance or annuity contracts.

Rev. Rul. 83-172, 1983-2 C.B.107, holds that a self-insured workers compensation arrangement qualifies for taxation as an insurance company under Section 831. In reaching its conclusion that the group in question was conducting an insurance business, the Service reasoned in Rev. Rul. 83-172 that the self-insurance arrangement constituted an insurance contract because it satisfied the essential insurance characteristics of risk shifting and risk distribution.

A number of court decisions have addressed the issue of whether a self-insured plan sponsored by an employer constitutes insurance for tax purposes. These decisions indicate that an employer's plan may be considered an insurance contract if the following elements are present: (1) risk shifting and risk distribution; (2) actuarial soundness; and (3) a binding commitment to pay benefits. See Helvering v. LeGierse, 312 U.S. 531 (1941); Ross v. Odom, 401 F.2d 464 (5th Cir. 1968) [68-2

U.S.T.C. par. 9587]; Davis v. U.S., 323 F.Supp. 858 (S.D. W.Va. 1971)[71-1-U.S.T.C. par. 9264]; and Haynes v. U.S., 353 U.S. 81 (1957), rev'g 223 F.2d 413 (5th Cir. 1955). These factors are discussed in more detail below.

1. Risk Shifting and Risk Distribution.

Risk shifting and risk distribution involve:

> the payment of premiums or assessments by a number of individuals into a common fund out of which the payor's estate or beneficiaries will be paid a certain amount upon his death regardless of whether the amount is more or less than the decedent has paid into the fund.

Commissioner v. Tighe, 33 T.C. 557, 564 (1959).

Risk-shifting, as noted by the Second Circuit, "emphasizes the individual aspect of insurance: the effecting of a contract between the insurer and the insured each of whom gamble on the time the latter will die." Commissioner v. Treganowan, 183 F.2d 288 (2d Cir. 1950) [50-1 U.S.T.C. par. 10,770]. Risk distribution, on the hand, emphasizes the "broader, social aspect of insurance as a method of dispelling the danger of the potential loss by spreading its cost throughout the group." Id. at 50-1 U.S.T.C. 12,875-91.

In Commissioner v. Treganowan, supra, the Second Circuit held that a death benefit plan under which the beneficiary of each plan participant would receive a $20,000 lump-sum payment "manifestly" produced a distribution of the risk. Treganowan, supra, at 50-1 U.S.T.C. 12,875-91. The Court based this conclusion on the fact that more than 1300 persons contributed to the fund from which death benefits were paid, and on the fund's actuarial soundness. Id. "Because of the plan," the Court held, "the risk of premature death is borne by the 1,373 other members of the [plan], rather than by the individual."

2. Actuarial Soundness.

Many of the judicial decisions have focused on the need for actuarial soundness for a self-insured plan to be considered "insurance" under the Code. For example, in Ross v. Odom, supra, the contributions to fund the state employee survivor's benefit fund were required by state law to be fixed based on "accepted actuarial computations." As found by the court:

> [O]n accepted actuarial principles, the size and composition of the group, and relevant expectancy and investments factors, the benefits prescribed could be discharged by the Survivors' Benefit Fund. . . . On both scores this was insurance.

68-2 U.S.T.C. at 88,036. See also Edgar v. Commissioner, 39 TCM 816, 822 (1979); Davis v. U.S., 323 F.Supp. 858 (S.D. W.Va. 1971) [71-1 U.S.T.C. par. 9264].

3. Binding Obligation to Pay Benefits.

Another factor emphasized by the courts is that the employer's promise to pay the death benefits in question must not be illusory. See, e.g., Davis v. U.S., supra, at 71-1 U.S.T.C. 86,031 (held, plan which fails to provide "definitely determinable death benefit" is not insurance). For example, where an employer-sponsored plan is terminable, the beneficiary's right to payment of benefits once death has occurred must be fixed and definite. In Ross v. Odom, supra, the court found several factors significant in reaching its conclusion that the life insurance arrangement there constituted a binding, enforceable obligation with assurances that funds to discharge the obligation would be both available and sufficient. Although the arrangement there was terminable, vested claimants were entitled to sue under state law if the claim was not paid. The investments permitted for the fund were carefully restricted and funds were protected by surety bonds. Finally, the contributions of the employers (participating state agencies) were ensured by compulsory budgeting under State law. Id. 68-2 U.S.T.C. at 88,039.

Ross v. Odom was decided prior to the enactment of ERISA (the Employee Retirement Income Security Act of 1974). Like the provisions of state law in Odom, safeguards are provided under ERISA which protect the rights of beneficiaries to receive all appropriate benefits under an employee welfare benefit plan such as a self-insured life insurance plan. ERISA requires that the named fiduciary of the Plan must operate the Plan prudently and in the interest of all participants and beneficiaries. ERISA §404(a)(1). The named fiduciary is obligated under ERISA to discharge his or her duties with respect to a plan "for the exclusive purpose of providing benefits to participants and their beneficiaries; and defray reasonable expenses of administering the plan". ERISA §404(a)(1)(A). Pursuant to ERISA, moreover, a beneficiary whose claim for benefits is

ignored or denied, in whole or in part, can file suit in state or federal court to recover any benefits payable under the plan. ERISA §404(a)(1)(A). These provisions support the conclusion that an employer self-insured plan may qualify as a life insurance contract under the authority of Odom.

4. Qualification of Self-Insurance.

The above result should not be affected by the fact that an employer's plan is not underwritten by a commercial insurance company, or the fact that an employer's accrued liability to make contributions to the Plan is not prefunded or segregated from the employer's general assets. See Haynes v. U.S., 353 U.S. 81 (1957), rev'g 223 F.2d 413 (5th Cir. 1956) [56-1 U.S.T.C. par. 9475], in which the United States Supreme Court held that an employer's self-funded plan qualified as health insurance for purposes of excludability from the income of the employees. The Court in Haynes states:

> The payment of premiums in a fixed amount of regular intervals is not a necessary element of insurance. Similarly, there is no necessity for a definite fund set aside to meet the insurer's obligations.

353 U.S. at 84.

The dissenting opinion in the Court of Appeals decision in Haynes (which was adopted by the Supreme Court in reversing the majority opinion of the Fifth Circuit) sheds further light on the issue of self-insurance. The dissent first notes that commercial insurance is generally more costly, and the government should not be in the position of second-guessing the employer's business decision to avoid such unnecessary costs.

5. Impact of Code Section 101(b).

The relevance of Section 101(b), which permits a limited exclusion of up to $5,000 for a death benefit provided by an employer, must be considered. This issue may be disposed of by examining the nature of the benefit. Section 101(b), in effect, refers to a form of deferred compensation rather than to insurance per se. Where an employer-provided arrangement contains the requisite aspects of insurance it constitutes a contract of life insurance within the meaning of Section 101(a) rather than a compensation arrangement under Section 101(b). Ross v. Odom, supra, 68-2 U.S.T.C. at 88,040.

Thus, it can be seen that, prior to the enactment of Section 7702(a), Section 101(a) could be interpreted to apply to a self-insured death benefit plan sponsored by an employer, provided the requisite aspects of "insurance" were present.

Section 7702(a)

Section 7702(a), added to the Code by the 1984 Reform Act, provides as follows:

> (a) General Rule. -- For purposes of this title, the term "life insurance contract" means any contract which is a life insurance contract under the applicable law, but only if such contract --
>
> (1) meets the cash value accumulation of subsection (b), or
>
> (2) (A) meets the guideline premium test of subsection (c), and
>
> (B) falls within the cash value corridor of subsection (d).

Subsections (1) and (2) of Section 7702(a) (the "cash value accumulation test", the "guideline premium test", and the "cash value corridor") are relevant only if the contract has an investment feature in addition to pure insurance protection. Thus, these provisions would have no application to an employer-sponsored plan providing only a death benefit without any accumulation of "cash value".

The reference to "this title" means the Internal Revenue Code. Thus, Section 7702(a) would literally apply to the use of the term "life insurance contract" in Section 101(a). If this application were given effect, a new requirement would be imposed for purposes of determining the availability of the Section 101(a) exclusion, viz., classification as a life insurance contract under "applicable law." As discussed below, we believe this result was unintended by Congress, and would seriously complicate an area of law that is relatively well settled.

1. "Applicable Law".

The Joint Committee report on the 1984 Tax Reform Act indicates that "applicable law" means applicable State or

foreign law. General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 646.

The determination of whether an arrangement would constitute a "life insurance contract" under the laws of many states is far from clear. Moreover, even if a reasonably clear determination can be made in a particular state (and assuming the IRS and the taxpayer can both agree, which is by no means certain), a different result might be reached in other states.

This point can be illustrated by briefly reviewing the law of several states. For example, Virgina law provides that "life insurance means... every insurance upon the lives of human beings and every insurance appertaining thereto payable in fixed or variable dollar amounts, or both." Va. Code §38.1-3. Maryland, Georgia, Florida, and Michigan, among others, have adopted similarly broad definitions of the terms "life insurance" and "life insurance contract." See Md. Ann. Code art. 48A, §63; Ga. Code Ann. §33-25-1; Fla. Stat. Ann. §624.602; Mich. Comp. Laws Ann. §24.1602. Georgia law, for example, provides that a contract of life insurance is one whereby the insurer, for a consideration, assumes an obligation to be performed upon the death of the insured . . ." GA. Code Ann. §33-25-1.

In light of these broad statutory definitions, it appears that the obligation under an employer's self-insured plan to pay death benefits to the survivors of participating employees could qualify as a "life insurance contract" in a number of states. A number of courts, in fact, have indicated that self-funded death benefit plans qualify as "life insurance" arrangements. For example, the Second Circuit noted that associations which collect assessments from their members and distribute these funds to the survivors of a deceased member "have always been understood to be insurance." Commissioner v. Treganowan, 183 F.2d 288 (2d Cir. 1950); see also State v. Dane County Mutual Ben. Ass'n., 247 Wis. 220, 19 N.W. 2d 303 (1945)(held, plans which impose assessments on members for purpose of creating a death benefit fund are a form of "life insurance"). A Texas court, moreover, held that a nonprofit association which paid death benefits to the survivors of deceased members was providing an insurance service. State v. Memorial Benev. Soc. of Texas, 384 S.W.2d 776 (Tex. Civ. App. 1964).

A number of state courts have held that employers who offer self-funded welfare benefit plans to their employees are not engaged in the "insurance business". See, e.g. Superintendent of Insurance v. Monsanto, 517 S.W. 2d 129 (Mo. 1974); Mutual

Life Insurance Co. of New York v. New York State Tax Commission, 32 N.Y. 2d 348, 298 N.E. 2d 632 (1973) (self-funded life insurance benefits provided to employees). The stated rationale for these decisions, however, was that the employers were simply providing a fringe benefit to their employees, and were not offering insurance services to the public at large. The decisions do not directly or indirectly hold that the benefit plans provided by the employers failed to qualify as "insurance." In many states, there is no statutory definition of the term "life insurance" and no case law indicating whether or not self-funded death benefit plans qualify as "life insurance" contracts. Therefore, in numerous states, it is uncertain whether an employer's plan could qualify as a "life insurance" arrangement.

2. Life Insurance Investment Contracts.

Section 7702 has its origins in the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"). In response to increased marketing by insurance companies of flexible premium life insurance contracts ("universal life" or "adjustable life" policies), Congress moved to correct what was viewed as a growing loophole. Such policies typically permitted the policy-holder to change the amount and timing of the premiums and the size of the death benefit automatically as desired. The Internal Revenue Service had ruled in a January 23, 1981 private letter ruling that the entire death benefit paid under a flexible premium insurance contract is excluded from gross income under Section 101(a), even though the death benefit may reflect a large cash value accumulation and only a small amount of pure insurance protection. Congress was also concerned that the interest on the cash fund was not subject to tax unless the policy was surrendered prior to the death of the insured.

In order to limit tax benefits available to overly investment oriented life insurance policies, TEFRA established temporary guidelines for death benefits under flexible premium policies to be treated as excludible under Section 101(a). Violation of the guidelines would subject the contract to be treated as a combination of term life insurance and an annuity or deposit fund, so that only the term life insurance component would qualify under Section 101(a).

The 1984 Tax Reform Act adopted rules similar to the temporary TEFRA provisions, but somewhat narrower because of the "general concern with the proliferation of investment-oriented life insurance products... ." (Joint Committee Report at p.646.) This concern represents the entire focus of Section 7702.

Nowhere in the legislative history is there evidence of any intent to prevent a non-investment oriented self-insured employee death benefit plan provided by an employer from qualifying as a life insurance contract under Section 101(a). Such plans do not involve any tax-free accumulation of cash value, but merely provide a death benefit on the death of the covered employee. Accordingly, if the requisite elements of risk shifting, risk distribution and actuarial soundness are present, Section 7702(a) should not preclude employer plans from qualifying under Section 101(a) solely because of the vagaries of state law.

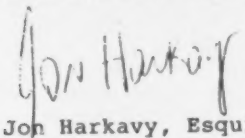
A possible interpretation of newly enacted 7702(a) of the Internal Revenue Code which may deny the non taxable status to beneficiaries of death benefits under self-funded employer provided arrangements, is not only outside the legislative intent of the statute, but is also clearly contrary to settled case law and existing Code sections. Notwithstanding this particular Code section, however, when Congress begins to consider overall tax reform, RIMS urges this Committee to adopt a more functional criteria of tax deductibility and tax free status than whether a benefit plan or risk financing mechanism is self funded or purchased from an insurance carrier. In the case of a death benefit, the policy behind the Section 101(a) life insurance exclusion is served whether the proceeds come from the employer's plan or a third party insurer. Where is the equity in taxing Widow A for a $20,000 employer provided death benefit, and leaving Widow B's $40,000 insurer provided death benefit untaxed? Similarly, what purpose is served by forcing an employer to purchase potentially more costly insurance from a third party insurer, when the employer can establish an actuarially sound plan on its own, with a binding commitment to pay benefits and losses? Blind adherence to the definition of insurance in these instances is not tax neutral. Rather it promotes inefficiency on the part of American business, and results in needless revenue loss by the Treasury.

Conclusion

Based on the foregoing, we propose the inclusion of an amendment to H.R. 1800 making a further technical correction to the 1984 Tax Reform Act, to specifically clarify that Section 7702(a) shall have no application to the classification of an employer death benefit plan as a life insurance contract under Section 101(a). We suggest the following underlined language be added to the Section 7702(a):

"(a) GENERAL RULE -- For purposes of this title, the term 'life insurance contract' means any contract which is a life insurance contract under the applicable law, without regard to any requirement under applicable law that such a contract be issued by an insurance company, but only if such contract... ."

Respectfully submitted,



Jon Harkavy, Esquire
Director of Governmental
Affairs, RIMS

STATEMENT OF ST. JOHNS RIVER POWER PARK SYSTEM

The St. Johns River Power Park System of Jacksonville, Florida, appreciates this opportunity to comment on the Technical Corrections Act of 1985 (H.R. 1800). In particular, we wish to advise you of our concerns over the retroactive elimination of the so-called "Construction or Binding Contract" exception for consumer loan bonds in section 169(a)(1) of such Act and the possible effect such provision would have on the St. Johns River Power Park System, a project supported by the Jacksonville Electric Authority ("JEA") and the Florida Power and Light Company ("FPL").

In the Deficit Reduction Act of 1984 (the "1984 Act"), Congress made substantial changes to those provisions of the Code relating to tax-exempt financing, including a provision (section 626(a) of the 1984 Act) which denies tax-exempt status to consumer loan bonds. Under the 1984 Act, a consumer loan bond is defined as any obligation (other than an industrial development bond, qualified student loan bond, or qualified mortgage bond or qualified veterans' mortgage bond) all or a significant portion of the proceeds of which are reasonably expected to be used directly or indirectly to make or finance loans to a nonexempt person. The internal effective date for this change is contained in section 626(b)(1) of the 1984 Act which provides:

"(1) IN GENERAL.—Except as otherwise provided in this subsection the amendments made by subsection (a) shall apply to obligations issued after the date of enactment of this Act.[1]

The 1984 Act goes on to provide in section 631(c) for general effective dates for those bond provisions without an internal effective date and for specific exceptions to the overall effective dates in the bond subtitle. Section 631(c), thus, currently provides in relevant part:

"(c) OTHER PROVISIONS RELATING TO TAX-EXEMPT BONDS.—

[1] Date of enactment was July 18, 1984. Thus, obligations issued after July 18, 1984, are governed by the new provision.

(1) IN GENERAL.—Except as otherwise provided in this *subtitle*, the amendments made by this subtitle shall apply to obligations issued after December 31, 1983.

* * * * * * *

(3) EXCEPTIONS.—

(A) CONSTRUCTION OR BINDING AGREEMENT.—The amendments made by this *subtitle* (other than section 621) shall not apply to obligations with respect to facilities—

(i) the original use of which commences with the taxpayer and the construction, reconstruction, or rehabilitation of which began before October 19, 1983, or

(ii) with respect to which a binding contract to incur significant expenditures was entered into before October 19, 1983.

(B) FACILITIES.—Subparagraph (C) of subsection (b)(2)(A) shall apply for purposes of subparagraph (A) of this paragraph." [Emphasis added.]

In light of the ambiguity of the cross references in the above-cited sections and the changes proposed in the Technical Corrections Act of 1985, a question has arisen as to whether the so-called Construction or Binding Contract exception in current section 631(c)(3)(A) is applicable to consumer loan bonds. That is, would a consumer loan bond issued after July 18, 1984, with respect to facilities the construction of which was begun before October 19, 1983, or with respect to which a binding contract to incur significant expenditures was entered into before that date, be exempt from the new restrictions (*i.e.*, would it remain tax-exempt).

As noted earlier, currently section 631(c)(1) provides a general rule that "except as otherwise provided in this subtitle" (the entire bond subtitle including the consumer loan bond provisions) the amendments made by the subtitle will apply to obligations issued after December 31, 1983. The internal effective dates are among the exceptions referred to in this general rule. Thus, the consumer loan bond effective date in section 626(b)(1) is an exception to this general effective date. Section 631(c)(3) [the Construction or Binding Contract exception] is also an exception to the December 31, 1983, general effective date. Furthermore, since the so-called internal effective dates are amendments made by the subtitle that are not contained in section 621, the internal effective dates (as well as section 631(c)(1)) are superceded by this section. Thus, this Construction or Binding Contract provision is also an exception to the entire tax-exempt bond effective dates provisions, including the consumer loan bond provisions of section 626(a) and (b).

Section 169(a)(1) of the Technical Corrections Act of 1985 would resolve this ambiguity to the detriment of parties who have issued bonds since July 18, 1984, relying upon the Construction or Binding Contract exception and would do so retroactively. Thus, under the Technical Corrections Act the Construction or Binding Contract exception would not be available to facilities financed or to be financed or refinanced with consumer loan bonds. The St. Johns River Power Park System (the "Power Park") is particularly concerned over the possible effect this subsequent retroactive change to the Construction or Binding Contract exception could have on our project.

The Power Park is a coal-fired generating facility, the construction and operation of which is a joint project of the Jacksonville Electric Authority, a political subdivision of the State of Florida, and Florida Power & Light Company, an investor-owned utility. Under the terms of the Joint Ownership Agreement between the JEA and FPL, which was entered into by such parties on April 2, 1982, FPL would receive output capacity from the JEA's 80% ownership interest in the Power Park, in general, for a 40-year period, for as much as (but no more than) twenty-five percent of the name plate capacity of the JEA's ownership interest in the facility. By private letter ruling dated April 8, 1983, to FPL, the Internal Revenue Service ruled that the bonds issued by the JEA under this arrangement would not be industrial development bonds.

Beginning in November, 1982, the JEA began issuing its St. Johns River Power Park System obligations; and to date in excess of $1.05 billion in bonds and $600 million in short-term bond anticipation notes and commercial paper have been issued. The JEA expects to issue approximately $750 million in additional revenue bonds to retire the short-term debt and to complete the project. At this point, over 90% of the construction contracts have been awarded, and those contracts contain various penalties for cancellation thereof. By June, 1984 over $250 million had been spent on construction. Currently, $400 million has been expended. Thus, the JEA and FPL at the time of enactment of the 1984 Act were well into the Power Park project, which had its inception in December, 1976. The feasibility of the project de-

pends heavily on the JEA's ability to finance its ownership interest with tax-exempt revenue bonds.

Section 169(a)(1) of the Technical Corrections Act, by eliminating the Construction or Binding Contract exception for consumer loan bonds in the 1984 Act, at least in our case, could jeopardize a mammoth construction project, the physical construction of which began in December, 1982 and which is not expected to be completed until approximately October, 1988. Should Internal Revenue Code Section 103(o) apply to future bonds issued by the JEA to finance the construction of the Power Park, not only would the financing of the anticipated $750 million of additional bonds be in jeopardy, but also the existing $1.6 billion in tax-exempt securities would be adversely impacted because of the affect of this development upon the feasibility of the Power Park. Further, the possible retroactive effect of the Technical Corrections Act could jeopardize the tax-exempt status of over $450 million in revenue bonds which were issued since July 18, 1984 (the effective date of the 1984 Act) should these obligations be classified as consumer loan bonds.

To attempt to change these provisions retroactively would work the harshest of injustice (a) upon bondholders who have purchased bonds since July 18, 1984, and (b) upon projects which, in customary legislative procedures, would normally have been provided transitional relief. Therefore, we respectfully request that the Committee revise section 169(a)(1) of the Technical Corrections Act of 1985 so as to ensure that an appropriate transitional rule providing for a Construction or Binding Contract exception for consumer loan bonds be available for projects like the St. Johns River Power Park System.

STATEMENT OF SALOMON BROS., INC.

The House Ways and Means Committee and the Senate Finance Committee are currently considering companion bills, H.R. 1800 [1] and S. 814 [2] respectively, that contain certain technical corrections to the Internal Revenue Code of 1954 (the "Code"). This legislation should include a provision correcting a serious problem in the application to *bona fide* securities dealers of the sections of the Code that deal with the taxation of commodities straddles. This technical correction is needed to carry out Congressional intent, as clearly expressed in the legislative history to both the original enactment of the straddle rules in the Economic Recovery Tax Act of 1981 ("ERTA") and the substantial revision of those rules in the Tax Reform Act of 1984, because (i) the final version of ERTA did not accurately reflect the intent of Congress with regard to the application to *bona fide* securities dealers of the straddle rules and (ii) the Congressional intent has been further frustrated by the failure of recently issued Treasury regulations to address the problems raised by the application to *bona fide* securities dealers of the straddle rules.

A. THE FINAL VERSION OF ERTA DID NOT ACCURATELY REFLECT THE INTENT OF CONGRESS WITH REGARD TO THE APPLICATION TO BONA FIDE SECURITIES DEALERS OF THE STRADDLE RULES

Title V of ERTA added section 1092 and section 1256 to the Code. Sections 1092 and 1256 were enacted by Congress to eliminate the abusive use by individual taxpayers of tax shelter straddles (especially the widely publicized silver straddles) to realize losses in one year while deferring roughly offsetting gains until a future tax year. To curtail these abuses, sections 1092 and 1256 require a taxpayer to defer any loss realized on the disposal of one of the two "offsetting" legs of a straddle if the leg that is retained has any offsetting gain.

Sections 1092 and 1256, however, were not intended to apply to legitimate hedging activities, entered into by taxpayers in the ordinary course of their business. Accordingly, section 1256(e) provides for a "hedging exception", under which certain transactions identified by the taxpayer as hedging transactions are removed from the scope of sections 1092 and 1256.

Banks and *bona fide* securities dealers, in the ordinary course of their day-to-day business, engage in a wide variety of hedging transactions on a massive and complex basis, purchasing and selling thousands of positions in securities each day to meet the requirements of their business and to hedge their exposure to various forms of financial risk. A large *bona fide* securities dealer may purchase and sell

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[1] 99th Cong., 1st Sess., 131 Cong. Rec. H1631 (1985).
[2] 99th Cong., 1st Sess., 131 Cong. Rec. S3687 (1985).

trillions of dollars of securities each year in the course of these day-to-day business and hedging activities.

As described more fully below, the legislative history to ERTA makes it clear that Congress intended all of this complex hedging activity of banks and *bona fide* securities dealers to come within the hedging exception to the straddle rules. However, notwithstanding this Congressional intent, the final version of ERTA assured that the complex hedging activities of banks would come within the scope of the hedging exception, while *bona fide* securities dealers were given no such assurance. In particular, the version of section 1256(e)(4) that was enacted by ERTA ensures that banks' day-to-day hedging activities will come within the hedging exception of section 1256(e) by eliminating the need for banks' hedging transactions to meet certain highly technical requirements of the hedging exception. This disparate treatment of banks and *bona fide* securities dealers is contrary to the legislative history of ERTA.

The source of the rule providing disparate treatment for banks and *bona fide* securities dealers under the hedging exception was the House Ways and Means Committee version of ERTA.[3] In particular, the bill reported by the House Ways and Means Committee contained a predecessor version of section 1256(e)(4) that applied only to banks.[4] Further, the legislative history to the House Ways and Means Committee bill emphasized that the Committee intended all of the complex hedging activity of banks to come within the hedging exception, while that legislative history made no similar reference to the complex hedging activity of *bona fide* securities dealers.[5]

By contrast, the Senate Finance Committee version of ERTA rejected any disparate treatment of banks and *bona fide* securities dealers under the hedging exception. In particular, the bill reported by the Senate Finance Committee contained no version of section 1256(e)(4). Further, the legislative history to the Senate Finance Committee bill made it clear that the Committee intended all of the complex hedging activity of banks *and bona fide securities dealers* to come within the hedging exception:

> Taxpayers, such as banks *or securities dealers,* who may conduct thousands of hedging transactions to hedge property held or to be held in their accounts, may identify such accounts as hedged accounts without marking individual items as hedges or hedged property, provided such accounts deal only with ordinary income (or loss) items.[6]

The conference agreement on ERTA adopted the Senate Finance Committee version of the straddle provisions.[7] However, notwithstanding the adoption of the Senate Finance Committee bill by the committee of conference, the text of the bill that was eventually enacted as ERTA contained a version of section 1256(e)(4) that applied only to banks. Thus, although the Senate Finance Committee bill rejected any disparate treatment of banks and *bona fide* securities dealers and the committee of conference adopted that Senate Finance Committee bill, a version of section 1256(e)(4) providing disparate and favorable treatment for banks was codified in the Internal Revenue Code. Neither the explanatory statement prepared by the committee of conference nor the General Explanation of ERTA prepared by the staff of the Joint Committee on Taxation explains this divergence between Congressional intent and the text of ERTA as enacted.[8]

In order to conform the text of section 1256(e)(4) to the intent of Congress in enacting the hedging exception to the straddle provisions, it is proposed that section 1256(e)(4) be amended so as to apply to *bona fide* securities dealers as well as banks.

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[3] H.R. 4242, 97th Cong., 1st Sess. (1981) (the "Tax Incentive Bill of 1981").

[4] *See* H.R. 4242, 97th Cong., 1st Sess. section 1092(e)(3)(C)(iii).

[5] "A special rule for banks, as defined in section 581, permits a bank to treat any transaction entered into in the normal course of its trade or business, as a hedging transaction, provided the transaction is so identified in a timely and proper manner and any gain or loss on the transaction is treated as ordinary income or loss. . . . In certain hedging transactions, for example, those conducted by banks, it may be extremely difficult to match a hedging contract with a specific hedged property. In such cases, it may be sufficient for [the] identification requirement to mark an entire account, such as a bank's securities trading account, as a hedged account, provided the bank's securities trading account produces only ordinary income or loss and is managed and recorded independently and separately from the bank's investment account (and any other capital asset account)." H.R. Rep. No. 201, 97th Cong., 1st Sess. 200-01 (1981).

[6] S. Rep. No. 144, 97th Cong., 1st Sess. 151 (1981) (emphasis supplied).

[7] *See* H.R. Rep. No. 215, 97th Cong., 1st Sess. 258 (gains and losses on straddles), 259 (hedging exception) (1981).

[8] *See* H.R. Rep. No. 215, 97th Cong., 1st Sess. 258-60 (1981); Staff of Joint Comm. on Taxation, 97th Cong., 1st Sess., General Explanation of the Economic Recovery Tax Act of 1981 at 299-300 (discussing the application of section 1256(e)(4) to certain ordinary income activities of banks).

This amendment would simply confirm the intent of the legislative history to ERTA that the ordinary business hedging activities of *bona fide* securities dealers, like the similar activities of banks, should be outside of the scope of sections 1092 and 1256.

Clearly the amendment that is proposed herein should not, and need not, apply to individuals who engage in tax shelter activities by purporting to be securities dealers. Accordingly, it is suggested that the amended section 1256(e)(4) apply only to banks and to those securities dealers that have been approved, on the basis of their achievements and standards of activity, to be U.S. government securities dealers reporting to the Market Reports Division of the Federal Reserve Bank of New York, or that are otherwise proven, to the satisfaction of the Secretary of the Treasury, to be *bona fide* securities dealers.

B. THE CONGRESSIONAL INTENT HAS BEEN FURTHER FRUSTRATED BY THE FAILURE OF RECENTLY ISSUED TREASURY REGULATIONS TO ADDRESS THE PROBLEMS RAISED BY THE APPLICATION TO BONA FIDE SECURITIES DEALERS OF THE STRADDLE RULES

In the absence of a technical amendment including *bona fide* securities dealers within the scope of section 1256(e)(4), *bona fide* securities dealers (unlike banks) will be forced to rely on Treasury regulations to clarify the fact that the wide range of their hedging activities qualifies for the hedging exception. However, as described below, recently issued Treasury regulations under sections 1092 and 1256 do not in any way address the application to *bona fide* securities dealers of the hedging exception. Further, it is understood that the Internal Revenue Service does not propose at any time in the near future to issue certain regulations needed by *bona fide* securities dealers to apply the hedging exception to the wide range of their hedging activities. Accordingly, in the absence of a technical amendment including *bona fide* securities dealers within the scope of section 1256(e)(4), the Congressional intent that the complex hedging activity of *bona fide* securities dealers come within the hedging exception will be further frustrated.

The legislative history to ERTA made it clear that Congress intended all of the complex hedging activity of banks and *bona fide* securities dealers to come within the hedging exception to the straddle rules. In the Tax Reform Act of 1984, Congress reiterated its intent in this matter by quoting with approval that part of the Senate Finance Committee report on ERTA that dealt with the complex hedging activity of banks and *bona fide* securities dealers and by specifically providing the Treasury Department with "authority . . . to exempt particular classes of taxpayers, *like bona fide government securities dealers* [from the additional identification requirements for the hedging exception authorized by the Act]." [9]

Notwithstanding this reemphasized Congressional intent, banks are assured under section 1256(e)(4) that their hedging activities will come within the scope of the hedging exception, while *bona fide* securities dealers have no such assurance. *Bona fide* securities dealers have therefore been forced *since 1981* to await the issuance of Treasury regulations to clarify the fact that the wide range of their hedging activities, similar in form and substance to those conducted by banks, would likewise qualify for the hedging exception.

The Internal Revenue Service has recently issued regulations dealing with certain issues arising under section 1092 and section 1256.[10] Those regulations do not in any way address the application of the hedging exception to *bona fide* securities dealers. Further, it is understood that the Internal Revenue Service does not propose to issue regulations fleshing out the basic concept of an "offsetting" position at any time in the near future. For the reasons described more fully below, in the absence of regulations specifying the types of position that will be considered to be "offsetting", *bona fide* securities dealers will find it extremely difficult to apply the hedging exception (or most of the other straddle rules) to the thousands of transactions conducted by such dealers each day in the course of their ordinary business.

The basic concept underlying the straddle rules is the concept of "offsetting" positions. A straddle is itself defined as two (or more) "offsetting" positions with regard to personal property and the straddle rules apply in general only when a taxpayer holds one (or more) straddles.

The hedging exception to the straddle rules in turn depends upon the concept of "offsetting" positions in at least two ways. First, a taxpayer has no need to qualify for the hedging exception unless positions held by that taxpayer are "offsetting" po-

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[9] H.R. Rep. No. 861, 98th Cong., 2d Sess. 906-07 (emphasis supplied).

[10] *See* regulation section 1.1092(b)-3T, regulation section 1.1092(b)-4T, T.D. 8008, 1985-9 I.R.B. 10; regulation section 1.1092(b)-1T, regulation section 1.1092(b)-2T, regulation section 1.1092(b)-5T, T.D. 8007, 1985-8 I.R.B. 30.

sitions (and, accordingly, would otherwise be subject to the straddle rules). Second, under the highly technical requirements for the hedging exception that presently apply to all taxpayers other than banks, a transaction cannot qualify for the hedging exception unless the positions in the transaction are, in effect, "offsetting" positions.

In the absence of regulations elaborating on the definition of "offsetting" positions, *bona fide* securities dealers find it extremely difficult to apply the hedging exception to their day-to-day business. Large *bona fide* securities dealers, in the ordinary course of their day-to-day business, engage in a huge variety of hedging transactions on a massive and complex basis, buying and selling thousands of positions in securities each day to meet the requirements of their business and to hedge their exposure to various forms of financial risk. Presently, such dealers are unable to ascertain which of their positions or combinations of positions qualify under the technical requirements for the hedging exception or, indeed, which of their positions or combinations of positions constitute straddles in the first place.

Section 1256(e)(4) ensures that banks will not face these problems by ensuring that the day-to-day ordinary business and hedging activities of banks will qualify for the hedging exception. The legislative history to the original enactment of the straddle provisions in ERTA and the legislative history to the amendment of those provisions in the Tax Reform Act of 1984 clearly indicate that Congress intended that the ordinary business and hedging activities of banks and *bona fide* securities dealers come within the hedging exception. Because regulations have failed to carry out this intent, a technical amendment to the Internal Revenue Code, including *bona fide* securities dealers within the scope of section 1256(e)(4), is needed.

Appendix

It is proposed to amend section 1256(e)(4) of the Internal Revenue Code to read as follows (with the suggested amendments in italic):

(4) Special rule for banks *and Bona Fide Securities Dealers.*— In the case of a bank (as defined in section 581) *or a dealer in securities,* subparagraph (A) of paragraph (2) shall be applied without regard to clause (i) or (ii) thereof. *For purposes of this paragraph, the term "dealer in securities" shall mean a person that is a dealer in U.S. government securities reporting to the Market Reports Division of the Federal Reserve Bank of New York, or any other person that the Secretary determines (by regulations or otherwise) to be a bona fide dealer in securities, and the term "securities" shall have the meaning specified in section 1236(c).*

Sea-Land Corporation

The Farragut Building • 900 17th Street, N.W. • Suite 1100 • Washington, D.C. 20006 • (202) 429-1674

May 10, 1985

The Honorable Daniel Rostenkowski
Chairman, Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

It is respectfully requested that language be included in The Technical Corrections Act of 1985, H.R. 1800, to correct an omission from Section 514 of the Highway Safety Act of 1982 (Highway Safety Act). That section imposes an excise tax on tires sold after January 1, 1984 under a progressive rate structure, the excise tax rate increasing with the weight of the tire. However, it omits reference to inner tubes, which had been subject to excise tax under the previous rate structure.

The result of this omission is that tubeless tires, which have been demonstrated to be much safer than tubed tires and which weigh no more than tubed tires when the weight of the inner tube is included, bear a significantly higher excise tax than comparable tubed tires. We believe that this anomaly should be corrected by adding the weight of inner tubes to the weight of the tire in which they are used, and have attached a proposed bill that would achieve this result. Also attached is an example which illustrates the significant difference in the amount of excise tax paid by Sea-Land and other users of the safer tubeless tires with excise tax paid by those using the more dangerous tubed tires both under the pre '84 excise tax rate structure and under the current rate structure.

The poor safety record of tubed tires compared with tubeless tires results from the use of a two-piece rim with tubed truck tires, while tubeless tires require only a one-piece rim. This was documented in a "60 Minutes" program that aired on March 8, 1981, which featured a segment on "Killer Wheels", ie, tubed truck tires.

Therefore, we respectfully request that this letter and attachments be inserted in the official record for H.R. 1800, and that the omission of the excise tax on inner tubes be corrected as set forth in the attached proposed bill.

Very truly yours,

SEA-LAND CORPORATION

Craig L. Jacobson

C. L. Jacobson
Corporate Tax Counsel

CLJ-0091B:bh

Attachments (2)

May 6, 1985

A BILL

To amend the Internal Revenue Code of 1954 with respect to the determination of weight for tires subject to excise tax.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, that section 4071(c) of the Internal Revenue Code of 1954 (providing for the determination of weight for tires subject to excise tax) is amended to read as follows:

"(c) DETERMINATION OF WEIGHT - For purposes of this section, weight shall be based on total weight inclusive of the weight of inner tubes used in conjunction with a tubed tire, but exclusive of metal rims on rim bases. Total weight of the articles shall be determined under regulations prescribed by the Secretary."

CLJ-0092B:bh

Example

Federal Excise Tax on Comparable Tubed and Tubeless Tires

Tax Before January 1, 1984

	Tire	Tube	Total Tax	Quantity	Annual Tax
Tubeless 11X22.5	9.29		9.29	25,000	$232,250
Tubed 1000X20	8.98	.84	9.82	25,000	$245,500

Tax After January 1, 1984

	Tire	Tube	Total Tax	Quantity	Annual Tax
Tubeless 11X22.5	16.29	--	16.29	25,000	$407,250
Tubed 1000X20	7.50	--	7.50	25,000	$187,500

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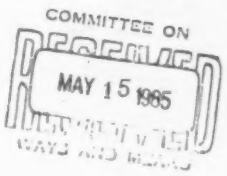
May 9, 1985



Joseph K. Dowley, Esq.
Chief Counsel
Committee on Ways and Means
1102 Longworth House Office
Building
Washington, D.C. 20513

Dear Mr. Dowley:

This letter is submitted for inclusion in the written record of the hearings to be held by the House Ways and Means Committee on May 16, 1985 on H.R. 1800, the Technical Corrections Act of 1985 (the "Bill"). My concern is specifically with reference to Section 152(e)(2) of the Bill which would repeal the present exemption from the gift tax of transfers pursuant to an exercise or nonexercise of an election under, inter alia, an individual retirement arrangement ("IRA") or a qualified plan (hereafter referred to as "retirement plans"). This gift tax exemption, embodied in section 2517 of the Internal Revenue Code of 1954, as amended (the "Code"), should, in fact, be broadened rather than repealed.

Section 2517 was added to the Code by the Technical Amendments Act of 1958 as an extension of the estate tax exemption which had been enacted in 1954 as section 2039(c) of the Code (relating to amounts receivable by a beneficiary under a retirement plan). The 1958 technical amendment was logical in that what was not includible in an individual's gross estate should not be taxed if transferred as a gift. It is apparently now assumed that the converse of the 1958 logic is true, i.e., that repeal of section 2517 is required as a technical correction as a result of the repeal of section 2039(c). Repeal is not required as a matter of logic and the following discussion demonstrates that repeal would result in substantive changes in existing law. The gift tax exclusion should be retained even in the absence of the estate tax exclusion, but in any event its repeal should not come about as the result of a minor item in a technical corrections bill.

Repeal of section 2517 would result in a taxable gift being made every time an individual causes the purchase or other establishment of a joint and survivor annuity under a retirement plan where the joint annuitant is someone other than the individual's spouse. A gift tax return would be required as a result of each such gift, regardless of the value, since the annual $10,000 gift tax exclusion is not available for gifts of future interests. While it is true that this filing requirement has in theory always applied to all contributory retirement plans, the impact has not been significant since the vast majority of retirement plans under which an annuity is paid are noncontributory. Repeal of section 2517 would cause gift tax considerations to apply for the first time to all employer-sponsored retirement plans as well as an entirely new category of retirement plans - IRAs.

The nature of these retirement plans, particularly IRAs and the typical defined benefit plan of large employers -- applying to a broad base of individuals in all income categories -- is such that the estate and gift taxes will probably not be owed by the vast majority of affected individuals. The Internal Revenue Service would probably not want the majority of affected taxpayers to comply with the filing requirements given the nature of the individuals involved and the thousands of superfluous gift tax returns that would have to be processed with full compliance.

Recently adopted retirement plan requirements are already complex enough, e.g., withholding elections under the Tax Equity and Fiscal Responsibility Act of 1982, minimum distribution requirements of the Tax Reform Act of 1984, and joint and survivor annuity elections and spouse's consent under the Retirement Equity Act of 1984, not to mention the complexities already in place under preexisting Code requirements, without adding another complexity in the form of gift tax considerations at the time elections regarding distributions are to be made. Sponsors of retirement plans would be required to disclose the gift tax ramifications, see, e.g., Treasury Regulation §1.408-6(d)(4)(iii)(B)(5). In fulfilling this disclosure obligation, sponsors would be required to attempt to explain to unsophisticated individuals the difference between designating a beneficiary to receive the balance of installment distributions in the event of premature death (which does not result in a taxable gift) and naming a joint annuitant on an annuity provided under the plan (which does result in a taxable gift). In this light, it is hard to reconcile the repeal of section 2517 of the Code with the present drive for tax simplification.

Because of the unlimited marital deduction, any gift involving a spouse escapes taxation in any event. Where the "donee" is not the spouse, the value of the survivor's interest will be includible in the "donor's" gross estate under section 2039 unless the joint annuitant precedeases the "donor". Since spouses are not taken into account, the revenue effect of retaining section 2517 will probably not be significant because either the chances of the beneficiary dying first are rather small (as in the case of a child as joint annuitant) or the value of the "gift" at the time of the "transfer" will probably be small (as in the case of a parent as joint annuitant).* Nor is it likely that the revenue effect of repealing section 2517 would be significant because credit against the estate tax owed on account of the survivor's annuity would be given under section 2012 of the Code for any gift tax paid when the joint annuitant is named. In all cases where the joint annuitant does survive, the value of the survivor's annuity included in the gross estate will be greater than the value of the gift so that no revenue will be lost as a result of diminution in value of the survivor's interest. Accordingly, the revenue interests of the United States Treasury are sufficiently protected if it is left to the executor or administrator of the estate of a qualified plan participant or IRA owner to ascertain the estate tax consequences of a survivor's annuity.

If repeal of the gift tax exemption is in fact desirable, it should be undertaken only after Congress gives careful consideration to all of its ramifications and not as a mere technical amendment. I am of firm belief that such repeal is not desirable considering the administrative burdens that would be placed on retirement plan sponsors, the resulting confusion of taxpayers and the expense that would be incurred by the Internal Revenue Service were all affected taxpayers to comply with the reporting requirements. Furthermore, I submit that the same considerations support expanding the scope of section 2517 to exempt transfers of annuities or other payments derived from employee contributions. Expansion of the exemption would be one step to simplify the Code by elimination of a tax obligation that is only honored in its evasion.

Very truly yours,

Michael P. Sjogren

MPSjogren
mc

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* In the case where the joint annuitant predeceases the "donor", in which event the "donee" receives nothing and the "donor" continues to receive a reduced pension, one questions the equity of imposing a gift tax on the "transfer" of the survivorship annuity in the first place.

STATEMENT OF SILVERSTEIN & MULLENS, WASHINGTON, DC, ON BEHALF OF ROLLS-ROYCE MOTORS, INC.

SECTION 112(e)(1)(b) OF THE TECHNICAL CORRECTIONS ACT OF 1985 (RETROACTIVE GAS GUZZLER TAX AMENDMENT)

This memorandum urges that the 8-year retroactive effect of Section 112(e)(1)(B) of the Technical Corrections Act of 1985 (the "Act") be deleted and that such provision (the Gas Guzzler Tax Amendment) only be applied prospectively from the date of enactment of the Act.

Rolls-Royce Motors Inc. ("Motors"), a domestic corporation with approximately 100 employees and headquartered in Lyndhurst, New Jersey, imports Rolls-Royce motor vehicles (approximately 1,000 in 1984) from its U.K. affiliated corporation (Rolls-Royce Motors Ltd.) which it sells to its franchised U.S. dealerships.

From 1980 through early 1985, Motors paid the "Gas Guzzler" tax imposed by Section 4064 of the Internal Revenue Code of 1954, as amended (the "Code"), pending the Treasury Department's consideration of Motors' applications (filed in 1979 and 1981) for use of "an alternative rate schedule" as a "small manufacturer." Both applications were denied on the ground that the use of Rolls-Royce vehicles in the United States does not serve "an important public policy", a requirement entirely formulated by the Treasury without any evident legislative support under Section 138.4064-1(d)(ii) of the Temporary Regulations.[1]

Shortly after receiving the denial of its second application for use of an alternative rate schedule in November 1984, Motors shifted the focus of its argument for relief from the Gas Guzzler tax to the fact that almost all Rolls-Royce models which it imports and sells have a gross vehicle weight rating greater than 6,000 pounds.[2] Because Section 4064(b)(1)(A) defines the word "automobile" as a "4-wheeled vehicle propelled by fuel * * * (i) which is manufactured primarily for use on public streets, roads, and highways * * * and (ii) which is rated at 6,000 pounds gross vehicle weight or less," Motors filed refund claims on March 18, 1985, based on the contention that none of the Rolls-Royce models with gross vehicle weight ratings greater than 6,000 pounds constitutes an "automobile" for purposes of the tax and on the fact that the tax was not passed through to dealers or consumers.[3]

Section 112(e)(1)(B) of the Technical Corrections Act of 1985 (H.R. 1800 and S. 814, introduced on March 28, 1985), would change the definition of the word "automobile" in Section 4064(b)(1)(A) by striking out the term "gross vehicle weight" and inserting in lieu thereof the term "unloaded gross vehicle weight." Since the Rolls-Royce vehicles in question appear to have an "unloaded gross vehicle weight" less

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[1] The legislative history to the Gas Guzzler tax strongly supports the primary assertion made in Motors' applications that the "public policy" requirement in the Temporary Regulations constitutes an improper gloss on the small manufacturer provisions in Section 4064(d). The Conference Report (H. Rep. No. 95-1773, 95th Cong., 2nd Sess.) to the Energy Tax Act of 1978 (P.L. 95-618) clearly states that the small manufacturer provisions of the Gas Guzzler tax (Section 201 of the Energy Tax Act) are "generally patterned" on the small manufacturer provisions of the Energy Policy and Conservation Act of 1975 ("EPCA") (P.L. 94-163). EPCA, in turn, provides alternative rate schedules from the Corporate Average Fuel Economy ("CAFE") standards for small manufacturers, but does not condition such relief on meeting a public policy requirement. Motors, in accordance with EPCA, has repeatedly been granted alternate rate schedules with substantially less onerous fuel efficiency requirements. See, *e.g.*, 49 C.F.R. Sec. 531.5(b)(2). Nowhere in the legislative background of the Gas Guzzler tax does there appear any articulation of the reasons underlying the enunciation of a "public policy" constraint upon grant of the "small manufacturer" alternate rate schedule.

[2] Gross vehicle weight rating is defined to mean "the value specified by the manufacturer as the loaded weight of a single vehicle." 49 C.F.R. §523.2. The "loaded weight of a single vehicle" includes the sum of "curb weight" (*i.e.*, the "weight of a motor vehicle with standard equipment including the maximum capacity of fuel, oil, and coolant, and if so equipped, air conditioning and additional weight optional engine"), "accessory weight" (*i.e.*, the "combined weight (in excess of those standard items which may be replaced) of automatic transmission, power steering, power brakes, power windows, power seats, radio, and heater, to the extent that these items are available as factory-installed equipment (whether installed or not))", "vehicle capacity weight" (*i.e.*, the "rated cargo and luggage load plus 150 pounds times the vehicle's designated seating capacity"), and "productions options weight" (*i.e.*, the "combined weight of those installed regular production options weighting over 5 pounds in excess of those standards items which they replace, not previously considered in curb weight or accessory weight, including heavy duty brakes, ride levelers, roof rack, heavy duty battery, and special trim"). See 49 C.F.R. §571.110

[3] Motors' refund claims were for Gas Guzzler taxes (approximately $5 million) paid from the first quarter of 1982 through the fourth quarter of 1984. Its 1980 and 1981 tax years were closed due to the running of the three year statute of limitations for refund claims.

than 6,000 pounds, they will be subject to the tax imposed by § 4064(b)(1)(A). The proposed amendment is retroactive to 1978 and, in view of the Treasury Department's denial of its applications for use of the alternative rate schedule, would make Motors fully liable for all taxes paid from 1980 through early 1985. Indeed, Motors is apparently the only taxpayer that would be so affected by the proposed amendment.

Our reasons in support of applying Section 112(e)(1)(B) prospecively only are as follows:

Retroactive application of the gas guzzler tax to Rolls-Royce is at variance with traditional congressional restraint with regard to retroactive tax legislation that adversely affects taxpayer interests.

Whether or not Congress would have rejected a clear proposal which expressly excluded Rolls-Royce vehicles from the Gas Guzzler tax is not at issue in this memorandum, since Congress in fact adopted a definition of "automobile" which effectively excluded such vehicles from the tax. It did so only after closely considering and rejecting one other alternative: a definition which would have empowered the Secretary of Treasury to tax certain passenger automobiles with gross vehicle weight ratings in excess of 6,000 pounds, such as, presumably, the Rolls-Royce vehicles currently excluded from the tax. Given the absence of any discussion to the contrary in the legislative history, Motors had every reason to believe that Congress intended to exclude vehicles with gross vehicle weight ratings in excess of 6,000 pounds from the tax and to rely on the clear language of the statute when filing its refund claims. Such reliance appeared not to have been misplaced, moreover, in view of the fact that Congress had never attempted to revise the statute to include vehicles such as Rolls-Royce model vehicles in the eight years since the statute had been adopted. Thus, the proposed "clarification",[4] which appears to apply only to Rolls-Royce model vehicles, should not be applied retroactively. To do so would be both unfair and at variance with traditional Congressional restraint with regard to retroactive tax legislation that adversely affects taxpayer interests and expectations.

A. DEVELOPMENT OF THE GAS GUZZLER TAX

(1) On May 16, 1977, then Secretary of Treasury W. Michael Blumenthal testified before the House Ways and Means Committee respecting the Carter Administration's proposed "Fuel Inefficiency Tax", the precursor to the Gas Guzzler tax. In the description of the tax attached to Secretary Blumenthal's prepared testimony, it was stated that for model year 1978, the tax would apply to "all passenger automobiles", generally defined as "4-wheeled vehicles * * * rated at 6,000 lbs. gross vehicle weight or less." [5] For 1979 and later model years, the tax would apply to "4-wheeled vehicles rated at more than 6,000 lbs. gross vehicle weight but less than 10,000 lbs. gross vehicle weight if the Secretary of Transportation determines that (i) it is feasible to establish fuel economy standards for such vehicles and that such standards will result in significant energy conservation, or, (ii) if such vehicles are of a type that the Secretary determines is substantially used for the same purpose as lighter vehicles." [6] The proposed inclusion of 4-wheeled vehicles rated at more than 6,000 lbs. gross vehicle weight but less than 10,000 lbs. gross vehicle weight mirrored the definition of "automobile" set forth in the Energy Policy and Conservation Act ("EPCA") (P.L. 94–163).

(2) On July 13, 1977, the Committee issued its Report on the Energy Tax Act of 1977 (H.R. 6831). In this bill, which had changed the "Fuel Inefficiency Tax" to the Gas Guzzler Tax, the Ways and Means Committee Report significantly reveals that, although the Committee was aware of the EPCA 6,000–to–10,000 pounds alternative definition of "automobile", it nevertheless chose to apply the Gas Guzzler tax to automobile vehicles having a gross vehicle weight rating *of no more than 6,000 pounds.*[7] This interpretation was confirmed by the Committee in a document [8] rejecting the Carter Administration proposal giving discretionary authority to the Secretary to tax vehicles with gross vehicle weight ratings between 6,000 and 10,000 pounds. In this respect, the Committee stated: "a gas guzzler tax would apply to the sale or initial lease by the manufacturer (or importer) of *automobiles* having a gross

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[4] *See* the Joint Committee on Taxation Description of the Technical Corrections Act of 1985 at page 52.

[5] *See* Ways and Means Committee Print on Tax Aspects of the President's Energy Program Hearings (95–21) at pages 22–23.

[6] *Id.*

[7] H. Rep. No. 95–496 (part III), 95th Cong. 1st Sess. at pages 47, 50.

[8] Ways and Means Committee Summary and Section By Section Description of Title II of the Energy Tax Act of 1977 (H.R. 6831) at page 38.

vehicle weight of *no more than 6,000 pounds* which fall below certain fuel efficiency standards established by the Committee." [Emphasis supplied].

Simultaneously, the Secretary of Transportation in regulations under EPCA recognized that some vehicles commonly considered as automobiles in fact have gross vehicle weight ratings in excess of 6,000 pounds: Section 523.3(b) of 49 C.F.R. provides, in pertinent part, that:

"[t]he following vehicles rated at more than 6,000 pounds and less than 10,000 pounds gross vehicle weight are determined to be automobiles:

(1) Vehicles which would satisfy the criteria in Sec. 523.4 (relating to passenger automobiles) but for their gross vehicle weight ratings."

Section 523.4 of 49 C.F.R., in turn, defines "passenger automobile" as "any automobile (other than an automobile capable of off-highway operation) manufactured primarily for use in the transportation of not more than 10 individuals."

(3) Upon passage of the Gas Guzzler tax by the House of Representatives on August 5, 1977, the Joint Committee prepared for the Senate Finance Committee a document [9] explaining the Carter Administration's position on the House-passed bill. Significantly absent from the explanation was any objection to the Committee's definition of "automobile"—that the Carter Administration had decided to drop its proposal to apply the Gas Guzzler tax to vehicles with gross vehicle weight ratings between 6,000 and 10,000 pounds.

(4) On October 31, 1977, the Senate adopted its own energy bill [10] from which a Gas Guzzler tax was absent. The Senate and House energy bills thereupon went to Conference, where the Senate Conferees agreed to the House-passed Gas Guzzler provisions. No further action on the Gas Guzzler tax was taken until November 9, 1978, when it was enacted as Section 201 of the Energy Tax Act of 1978.

B. TECHNICAL CORRECTIONS ACT OF 1985

In its final form, the Gas Guzzler tax definition of "automobile" included all vehicles traditionally considered automobiles, with the significant exception of most Rolls-Royce model vehicles. Section 112(e)(1)(B) of the Technical Corrections Act of 1985 would repeal the de facto exclusion from the Gas Guzzler tax given to such vehicles. While Congress may not have intended to exclude any Rolls-Royce vehicles when it adopted the Gas Guzzler tax, it did not make that intention clear in the statute or the legislative history. To the contrary, Congress gave taxpayers (specifically Motors) every reason to believe that it had intended to tax only passenger automobiles with gross vehicle weight ratings not in excess of 6,000 pounds. It specifically rejected a proposal to give the Secretary of Treasury power to tax certain vehicles—such as the Rolls-Royce model vehicles at issue herein—in excess of 6,000 pounds and did not attempt to revise the de facto exclusion given to such vehicles for eight years. The proposed amendment constitutes a substantive retroactive change in the law made without notice to the one taxpayer (*i.e.*, Rolls-Royce) it adversely affects and, therefore, is inconsistent with traditional Congressional self-restraint with respect to substantive retroactive changes in the tax law.[11]

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[9] Such document was issued on September 16, 1977, set forth (at pages 16–20).

[10] Senate action occurred with respect to H.R. 5263, a House-passed bill originally dealing with an import tariff on bicycle parts.

[11] *See, e.g.*, the opposition to retrospective tax legislation expressed by the Senate Finance Committee in connection with a bill introduced in 1950 to revise the formula for the taxation of life insurance companies to increase revenues: Even if your committee were of the opinion that a tax levied now on 1947 and 1948 incomes would be upheld by the Supreme Court, it would still oppose retroactive taxation extending over such a long period of time. The imposition of a tax on 1947 and 1948 incomes at this late date would be inconsistent with fundamental public policy which requires that a taxpayer's obligation to his Government be made definite and certain at the time the tax is due. S. Rep. No. 2375, 81st Cong., p. 39, August 22, 1950. *But see* Section 641(b)(3) of the Tax Reform Act of 1984, which provides, in essence, that interest on bonds issued pursuant to the Housing Act of 1937, 42 U.S.C. §1437i(b), is not exempt from Federal estate and gift taxes. Section 641(b)(3) was added during the House-Senate Conference on the 1984 Act after it had become apparent that numerous taxpayers were taking advantage of a "windfall" created by a U.S. District Court decision that such bonds are exempt from Federal estate tax. See, *Haffner* v. *U.S.*, 585 F. Supp. 354 (N.D. Ill. 1984), aff'd,———F. 2d———(7th Cir. 1985). Although there continues to be much debate over the fairness of making the provision retroactive to 1937, it is clear that Congress never purposefully exempted Section 11(b) bonds from Federal estate and gift tax when it adopted the Housing Act of 1937.

C. CONCLUSION

Congress was purposeful when it limited the scope of the Gas Guzzler tax to automobiles with less than 6,000 pounds gross vehicle weight ratings and, by the same token, achieved precisely what it intended to achieve when it gave the Secretary of Transportation authority to include automobiles with gross vehicle weight ratings between 6,000 and 10,000 pounds in the definition of "passenger automobile" for purposes of the EPCA. Congress specifically rejected the original Carter Administration proposal to grant similar authority to the Secretary of Treasury for purposes of the Gas Guzzler tax. In so doing, it effectively excluded most Rolls-Royce vehicles from the tax. Whether or not such an exclusion was intentional is not the subject of this request. It is both harsh and extraordinarily unfair for Congress to attempt to correct a statute on an 8-year retroactive basis without any notice to and at the expense of the one taxpayer that was entitled to rely and in fact relied on the exclusion. In view of the inherent equities, Motors' unique circumstances and the relatively small amount of revenue involved, the proposed amendment to the Gas Guzzler tax should be prospective only.

STATEMENT OF THE STOCK COMPANY INFORMATION GROUP

The Stock Company Information Group appreciates this opportunity to submit comments to the Committee on Ways and Means respecting the insurance-related provisions of H.R. 1800, the proposed Technical Corrections Act of 1985 (the "bill"). These provisions appear as Part B of Title I of the bill, sections 121–128.

The Stock Company Information Group consists of 25 investor-owned life insurance companies. Taking into account its members' affiliated companies, the Group encompasses a majority of the 50 largest life insurance companies in the United States. The Group was organized in 1981 to monitor tax legislative developments and to convey the views of its membership on life insurance tax issues to the various insurance trade associations and to the Government. A list of our member companies is appended to this statement.

We are pleased to convey the support of our Group for the provisions of Part B of Title I of the bill. While we are generally quite satisfied with the life insurance tax revisions enacted as Title II of the Tax Reform Act of 1984 (the "1984 Act"), we welcome the several clarifying and correcting changes that the bill would make. Before turning to the few additional changes that we would urge be included in the bill, we wish to note our particular concern with certain of the items that the bill already covers.

As you know, representatives of the Stock Company Information Group were privileged to work with members and staff of the Ways and Means Committee, as well as with their counterparts in the Senate and with officials of the Treasury Department, in the development of the life insurance tax provisions of the 1984 Act. One of the most significant decisions made by the Ways and Means Committee, and ultimately by Congress, in writing those provisions was to preserve the rules of former section 815 of the Internal Revenue Code (the "Code") as they related to the balances in stock life insurance companies' policyholders surplus accounts at the close of 1983. Thus, under new section 815(f) of the Code, "the provisions of subsections (d), (e), (f), and (g) of section 815 . . . as in effect before the enactment of the Tax Reform Act of 1984" are made applicable "in respect of any policyholders surplus account for which there was a balance as of December 31, 1983."

Subsequent to that enactment, a question arose as to the treatment under section 815 of bona fide loans made by a stock life insurance company to an affiliated corporation. Such loans had never before been treated as distributions subject to the rules of section 815, and it therefore should have been clear that that treatment was to be continued under the rules of the 1984 Act, consistent with the foregoing decision of Congress. To confirm this and dispell all doubt, section 121(j) of the bill appropriately provides that an "indirect distribution" within the meaning of new section 815(a) of the Code "shall not include any bona fide loan with arms-length terms and conditions." The members of our Group strongly endorse this provision.

Another significant judgment made by Congress last year was that, for the taxable year 1984, mutual life insurance companies should pay 55 percent of the industry's total income tax burden (estimated to be approximately $3.1 billion). Of all the decisions that made up Title II of the 1984 Act, the implementation of this one was perhaps the most fraught with technical difficulty. The primary mechanism instituted to accomplish this goal was the disallowance of deductions for dividends and other items by means of the formula appearing in new section 809 of the Code. While a similar goal was accomplished by a similar route under prior law, the spe-

cific mechanics of the 1984 Act in this respect are new and untested. It is therefore totally appropriate, and not unexpected, for the bill to make the number of changes that it does in the rules of section 809 and related provisions.

For example, as foreshadowed in a measure introduced last fall (H.R. 6312) by Chairman Rostenkowski and former Representative Conable, section 121(c) of the bill would preclude companies from receiving tax benefits by accelerating the accrual of policyholder dividends. It seems that the emphasis new section 809 places on a mutual company's "equity base" was encouraging certain companies, at little or no economic detriment to themselves, to change their business practices so as to cause policyholder dividends that would normally have been declared in subsequent taxable years of the companies (i.e., the dividends would have been declared as of the various policy anniversaries occurring in the subsequent years) to become creditable to the policyholders in earlier taxable years. In this fashion, these companies attempted to meet the technical requirements for accelerated accrual of such dividends and thereby, arguably, to remove those dividends from the equity base. We understand it was a mutual company (or companies) that called this situation to the attention of congressional staff out of a concern that, by employing such a device, other mutual companies would fail to pay their requisite shares of tax, producing a shortfall in tax revenues from the mutual segment of the industry. We commend the Committee and its staff for their efforts to secure fulfillment of the intent of Congress that the mutual segment pay 55 percent of the industry's projected tax revenues. We also commend that mutual company (or companies) for focusing in a forthright manner on the principal, if not the sole, purpose of section 809.

We urge Congress and the Treasury Department to remain watchful over the new and untried rules of section 809, in order that they may achieve their intended purpose. Absent an appropriately strong mechanism of this sort, the express intent of Congress (as previously agreed to by mutual companies) that mutual companies should pay 55 percent of the industry's tax burden will not be realized. If this occurs, the total tax collections will be diminished in the amount of the mutual segment's shortfall, and stock companies will be forced to labor under a tax-induced competitive disadvantage.

The bill also makes several changes in the recently enacted rules bearing on annuity contracts, including variable annuities. These are found, respectively, in section 126 of the bill (amending section 222 of the 1984 Act and section 72(q) and (s) of the Code) and section 121(1) of the bill (amending section 817(h) of the Code). We understand that the Committee of Annuity Insurers, with which our Group has members in common, will also be filing a statement with you commenting on these provisions. We wish to take this opportunity to state our agreement with those comments. We commend them to you for prompt and favorable action.

We now turn to the items—three of them—that we would have you add to the bill. As we will presently explain, we believe that the bill should be amended to: (1) include in the first sentence of section 805(a)(4)(C) of the Code, which defines the term "100 percent dividend," a reference to section 245(b) of the Code; (2) coordinate section 121(c) of the bill (mentioned above) with section 419(e) of the Code (which defines the term "welfare benefit fund") as it would be amended by section 151(a)(8) of the bill; and (3) clarify the intent of the "deemed exchange" rule of subsection (f)(7)(B) of section 7702 of the Code, which defines the term "life insurance contract."

(1) 100 PERCENT DIVIDENDS—SECTION 805(A)(4)(C) OF THE CODE

As revised by the 1984 Act, section 805(a)(4) of the Code permits a life insurance company, in determining its "life insurance company taxable income," to deduct inter-corporate dividends received as provided in sections 243, 244, and 245 of the Code. See section 805(a)(4)(A). In so doing, the 1984 Act provision introduces the concept that "100 percent dividends"—those that are received from certain controlled subsidiaries in accordance with a special election—are deductible by the life insurer without regard to "proration" between the company and its policyholders under the formula of section 812 of the Code. For this purpose, section 805(a)(4)(C) defines such dividends to include "any dividend if the percentage used for purposes of determining the deduction allowable under section 243 or 244 is 100 percent." Curiously, this definition fails to refer also to section 245(b) of the Code, which employs "100 percent" in determining the deduction it allows corporations for certain dividends they receive from wholly owned foreign subsidiaries (where all of the subsidiaries' gross income is effectively connected with the conduct of a U.S. trade or business).

We believe that the omission of the reference to section 245(b) was unintentional. Section 245 was, in fact, referred to in section 805(a)(4)(A), and there is no reason why it should not also be incorporated into the subparagraph (C) definition of 100

percent dividends. Since the intent of Congress in writing new section 805(a)(4) was to provide a proration-free treatment for 100 percent dividends received by life insurance companies, and since section 245(b) dividends are accorded treatment equivalent to 100 percent dividends under sections 243 and 244 when received by all other corporate taxpayers, the bill should amend the section 805(a)(4)(C) definition to include a reference to section 245(b). Accordingly, we suggest that the subparagraph (C) definition be revised by deleting the phrase "section 243 or 244" and by substituting "section 243, 244, or 245(b)" in its place.

(2) POLICYHOLDER DIVIDENDS AND WELFARE BENEFIT FUNDS—SECTIONS 121(c) AND 151(a)(8) OF THE BILL

Section 121(c) of the bill would cause a life insurance company to lose (in effect) its "fresh start" adjustment for policyholder dividends granted by the 1984 Act to the extent that its deduction for policyholder dividends was "accelerated" by virtue of a change in business practices. This would be effected by adding a new section 808(f) to the Code, which would deny such a company a deduction for policyholder dividends in the amount by which the business practice change otherwise results in an increase in the deduction (limited to the amount of the fresh start adjustment). In our discussion above, we noted that the purpose of section 121(c) was to preclude the enhancement of deductions by accelerating dividends normally accrued at contract year-ends falling within a later taxable year of the insurer to dates coinciding with an earlier taxable year. We also endorsed its enactment.

As currently drafted, however, section 121(c) of the bill would possibly, and improperly, draw within its ambit a situation in which (in response to another rule involved in the bill) policyholder dividends were "accelerated" merely to fall within the taxable year of the insurer in which the contract anniversary to which the dividends relate occurred. Just such an advancement of the dividend date may be appropriate to conform with the practices of certain group contract policyholders (typically employers) who, in order to avoid classification of their contracts as "welfare benefit funds" under new section 419(e) of the Code (added by the 1984 Act) as it would be amended by section 151(a)(8) of the bill, must include in income in the taxable year in which their contracts end any policyholder dividends with respect to the contract year just completed. To conform its accounting with these new practices brought about by the amendment proposed in section 151(a)(8), an insurer might properly seek to accelerate the accrual of dividends from a customary time, such as within several months after the close of the contract year, to an earlier time that coincides with the contract year-end.

To coordinate the effects of sections 121(c) and 151(a)(8) of the bill, we suggest that section 121(c) be amended to state that the provisions of new section 808(f) will not apply to policyholder dividends declared with respect to contract years that have expired in or with the taxable year of the insurance company. This would make it clear that group contract dividends declared with respect to policy periods which had completely expired by the end of the insurer's taxable year (typically the calendar year-end) would not be considered impermissibly "accelerated" within the meaning of section 121(c) of the bill and proposed section 808(f) of the Code.

(3) THE "DEEMED EXCHANGE" RULE—SECTION 7702(f)(7)(b) OF THE CODE

In his floor statement introducing H.R. 1800, Chairman Rostenkowski observed that "[s]ome provisions [of the bill], such as the attempt to clarify the 'changes' insurance provisions . . . will continue to be the subject of work at the staff level." The Chairman's reference here was to the rule of subsection (f)(7)(B) of new section 7702 of the Code, which defines the term "life insurance contract" for all purposes of the Code. Section 7702(f)(7)(B) provides that any change in the terms of a life insurance contract which results in a reduction in the contract's future benefits is considered to give rise to an "exchange" of the contract for a new contract. It is therefore sometimes called the "deemed exchange" rule and, since it potentially carries major implications for the taxation of amounts distributed from a life insurance contract in connection with a partial surrender, it is also known as the "partial surrender" provision.

The members of the Stock Company Information Group strongly agree with the Chairman that the bill should contain an amendment to clarify the import of section 7702(f)(7)(B). The deemed exchange rule has been the subject of much misinformation within the life insurance industry, and we believe its clarification to be imperative. The problem here appears to stem from the fact that the statutory language, the related committee reports, and the explanation subsequently published by the staff of the Joint Committee on Taxation are not consonant with one an-

other. Taxpayers—both insurers and their policyholders—find themselves wondering which official version to follow.

Since, as the Chairman indicated, work has been proceeding at the staff level, we will not take up the Committee's time elaborating on the problem in this statement. Suffice it to say that it is of great importance to us that the definition of "life insurance contract" enacted by the 1984 Act succeed in its endeavor to distinguish between life insurance contracts and financial instruments used primarily for investment (particularly short-term investment) purposes. The rules of section 7702(f)(7) play a vital role in this endeavor. The members of our Group worked for the enactment of the provisions of section 7702, and we are anxious to participate with staff in the framing of a clarifying amendment for subsection (f)(7)(B) and then to support its enactment as part of H.R. 1800.

CONCLUSION

In sum, with the few points noted above, we are pleased to affirm our support for the provisions of Part B of Title I of the bill. We offer our assistance to the members and staff of the Committee as efforts progress to refine and enact this bill.

STOCK COMPANY INFORMATION GROUP—MAY 28, 1985

Aetna Life Insurance Company, Allstate Life Insurance Co., American General Life Insurance Company, Business Men's Assurance Company of America, Capital Holding Corporation, CNA Insurance, Connecticut General Life Insurance Company [CIGNA].

Federal Kemper Life Assurance Company, Franklin Life Insurance Company, Hartford Life Insurance Company, E.F. Hutton Life Insurance Company, IDS Life Insurance Company Insurance Company, Integon Life Insurance Corporation.

J.C. Penney Life Insurance, Jefferson Standard Life Insurance Company, Liberty Life Insurance Co., Liberty National Life Insurance Company, Life Insurance Company of Virginia, Lincoln National Life Insurance Company, Paul Revere Life Insurance Company, Provident Life and Accident Insurance Co., Southwestern Life Insurance Company, Transamerica Occidental Life Insurance Company, Travelers Insurance Company, Washington National.

STATEMENT OF J. WALKER STURDIVANT AND STEVEN F. NAIL, CAMPBELL & DELONG, GREENVILLE, MS

INTRODUCTION

Due to an oversight in the Tax Reform Act of 1984 regarding the tax consequences of a distribution of accumulated income of a domestic international sales corporation (DISC) to a non-exempt cooperative, we respectfully submit the following proposal which we suggest be included in and as a part of the Technical Corrections Bill of 1985.

TAXATION OF A NON-EXEMPT COOPERATIVE

Any corporation operating as a non-exempt cooperative may deduct from income (in addition to the other allowable deductions) certain distributions to its patrons. This income, which is often referred to as "patronage-sourced" income and which is basically determined by reference to the net earnings of the cooperative from business done with or for its patrons, is deductible to the cooperative and includable in the income of the patron. Thus, a non-exempt cooperative has been described as "a hybrid business organization, taxed like an ordinary corporation with respect to non-patronage-sourced income, but like a partnership with respect to patronage-sourced income." *Farm Service Cooperative* v. *Commissioner*, 619 F.2d 718 (8th Cir. 1980).

Patronage-sourced income will be deductible by the cooperative under § 1382(b)(1) of the Internal Revenue Code provided it is paid within the payment period set forth in § 1382(d) and will be includable in the income of the patron as a qualified patronage dividend under § 1385. In this respect, cooperatives are taxed like partnerships.

Dividends received by a cooperative from its wholly owned DISC is a patronage-sourced income. Rev. Rul. 75-228, I.R.B. 1975-24, 12; Private Letter Ruling 820811.

TAX REFORM ACT OF 1984

The Tax Reform Act of 1984 provided that accumulated income of a DISC derived before January 1, 1985, will be exempt from tax if the income is distributed after December 31, 1984. The Senate Finance Committee stated that the accumulated DISC income will "be treated as previously taxed income." This, of course, means that a shareholder of a DISC would receive all of the pre-1985 accumulated DISC income tax-free.

Unfortunately, neither the Tax Reform Act of 1984 nor the Committee Reports address the question of whether this pre-1985 accumulated DISC income, when distributed to a patron of a non-exempt cooperative, would also be tax-exempt. Since the Tax Reform Act of 1984 overlooked this question, the ordinary rules governing distribution of money by a non-exempt cooperative to its patrons would govern.

I.R.C. § 1385(a) requires, generally, that every patron include in his gross income any amount received by him in money, a qualified written notice of allocation, or other property, unless such an amount is excluded from gross income under provisions of I.R.C. § 1385(b) or (c). Section 1385(b) provides that a patron may exclude from gross income amounts received by a cooperative which are either properly taken into account as an adjustment to basis of property or are attributable to personal, living or family items. Obviously, § 1385(b) does not apply to exempt DISC income.

Section 1385(c) provides that a patron is not required to include in his gross income any non-qualified written notice of allocation which was paid as a patronage dividend. Again, § 1385(c) does not apply to exempt DISC income.

CONCLUSIONS

Since there is no statutory basis for distribution of DISC income to patrons of non-exempt cooperatives tax-free, we respectfully request that this oversight be rectified in the Technical Corrections Bill of 1985. Since Congress clearly intended that shareholders of a DISC receive tax-free the DISC's pre-1985 income, it would be unfair to penalize the shareholders of a cooperative. The theory underlying the tax treatment of a cooperative is clear: The cooperative is merely an agent for the patron, and any money which is returned to the patron is money that always belonged to the patron. Therefore, since a cooperative is no more than a conduit for its patrons to the extent of patronage-sourced income of the cooperative, patrons should receive the pre-1985 accumulated DISC income tax-free.

Furthermore, since a non-exempt cooperative is taxed like a partnership to the extent of its patronage-sourced income and since the partners of a partnership which was a shareholder of a DISC would receive the pre-1985 accumulated income tax-free, it would be unfair to patrons of a non-exempt corporation to include in their income the pre-1985 accumulated DISC income and not to include in the income of a partner the pre-1985 accumulated DISC income.

We would suggest that such a Technical Corrections amendment should not cost the Government the loss of any tax revenue since we would request that a non-exempt cooperative forfeit its right to a deduction on the distribution of DISC income to its patrons. In other words, instead of requiring the patrons of a non-exempt cooperative to report the DISC income as taxable income and instead of having a non-exempt cooperative enjoy an offsetting deduction, the DISC income should flow from the non-exempt cooperative to the patrons without triggering any taxable or deductible event.

Finally, in light of the present economic plight of farmers, such a Technical Corrections Bill would correct the obvious oversight and would be an excellent way of helping farmers who desperately need additional funds.

SULLIVAN & CROMWELL,
New York, NY, May 8, 1985.

JOSEPH K. DOWLEY,
Chief Counsel, Committee on Ways and Means, House of Representatives, Longworth House Office Building, Washington, DC.

DEAR SIR: In response to the invitation of the Committee of Ways and Means set forth in press release number 10, we are writing to urge that Section 109(b)(2) of the Technical Corrections Act of 1985, H. R. 1800 and S. 814 (the "Act"), which provides that Section 168(f)(10) of the Internal Revenue Code of 1954, as amended (the

"Code"), will not apply in the case of a deemed termination of a partnership under Section 708(b)(1)(B) of the Code,[1] be deleted or modified.

Currently, Section 168(f)(10) of the Code provides that the transferee of property is treated in the same manner as the transferor in calculating cost recovery deductions with respect to so much of the basis of the property in the hands of the transferee that does not exceed the adjusted basis in the hands of the transferor when the transferee acquires property in certain transactions, including distributions from, and contributions to, a partnership. Accordingly, cost recovery deductions allowable to a continuing partner are not affected if the partnership is deemed terminated under Section 708(b)(1)(B) of the Code because the continuing partner is deemed to have had its share of partnership property distributed to it and subsequently recontributed to the "new" partnership.[2] Thus, under Section 168(f)(10) of the Code, the "new" partnership is treated as if it were the old partnership in calculating cost recovery deductions because both transactions (the distribution under Section 731 of the Code and the recontribution under Section 721 of the Code) are transactions in which the transferee is treated as a transferor for the purposes of calculating cost recovery deductions.

If Section 109(b)(2) of the Act is enacted, however, Section 168(f)(10) of the Code will not apply to the deemed distribution or to the deemed contribution and the "new" partnership will not calculate cost recovery deductions in the same manner as an old partnership. Thus, the "new" partnership would be treated as if it acquired its property upon its formation, and the partnership would be required to claim cost recovery deductions with respect to its adjusted basis in partnership property over a new recovery period even though the partnership's basis is a substituted basis under Section 723 of the Code.

The application of this rule can best be illustrated by the following example: A, B, C, D and E are equal partners in XYZ partnership to which each contributes $600,000. On January 1, 1985, XYZ purchases its only asset, an office building, for $3 million. If XYZ elects to claim cost recovery deductions under the straight-line method, XYZ's adjusted basis in the office building on January 1, 1991 would be $2 million. Assuming A, B, and C sell their interests to F on January 1, 1991, XYZ would be deemed terminated and "new" XYZ would be required to claim cost recovery deductions with respect to its $2 million adjusted basis in the office building over an eighteen year period which begins in 1991. As a result, D's and E's distributive share of cost recovery deductions with respect to the office building are allowable over a twenty-four, rather than an eighteen, year period even though neither D nor E has transferred its partnership interest. This result clearly is unfair with respect to both D and E because both are treated as if they acquired property which they previously did not own.

With respect to continuing partners, this rule is inconsistent with the general carryover tax treatment of contributions and distributions of property to and from a partnership. In the above example, if XYZ were liquidated by distributing undivided interests in the building to its partners and the partners retained their undivided interests, the distribution would be a transaction to which Section 168(f)(10) of the Code applied and A, B, C, D and E would be treated in the same manner as XYZ for the purposes of calculating cost recovery deductions. Subsequently, if A, B and C sold their undivided interests in the building to F who persuaded D and E to join him in contributing the undivided interests in the building to MNO partnership, under Section 168(f)(10) of the Code, cost recovery deductions allowable to MNO with respect to the undivided interests contributed by D and E would be calculated in the same manner as if D and E had retained their interests.[3] Thus, if D and E were specially allocated the cost recovery deductions with respect to the undivided interests they contributed, their cost recovery deductions would not be affected by the distribution and recontribution. Except timing differences, a termination of a partnership under Section 708 of the Code is no different from this transaction and, if it is determined that the application of Section 168(f)(10) to a termination of a partnership should be changed, we believe it should be modified to provide for the

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[1] Section 708(b)(1)(B) provides that a partnership will terminate if there is a sale or exchange of 50% or more of the total interest in partnership capital or profits within a twelve month period.

[2] Under Section 731 no gain or loss is recognized in the distribution of property by a partnership to a partner, and under Section 721 no gain or loss is recognized in the contribution of property by a partner to a partnership.

[3] Similarly, cost recovery deductions allowable to MNO with respect to the undivided interests contributed by F would be calculated as if F retained the interests.

result described above because the continuing partners would not be affected (either adversely or positively) by the termination.

In addition, we do not believe that this amendment is necessary to prevent any potential abuses. Under Proposed Regulation Section 1.168-2(n) any increase in the basis of partnership property resulting from a Section 754 election is taken into account as if it were newly acquired recovery property. Thus, a new partner would not be entitled to claim cost recovery deductions over a period shorter than the statutory recovery period with respect to the premium paid over the transferee partner's share of the adjusted basis of partnership property.

As described above, the amendment would unfairly penalize continuing partners without preventing any abuses. Moreover, this amendment would result in a substantive, not technical, change in law which is not the purpose of the Act. Accordingly we recommend that Section 109(b) of the Act should be deleted or, if not deleted, modified as described above.

If you have any questions with respect to the foregoing or if we could be of assistance redrafting this section of the Act please call either of us at 212-558-4000.

Respectfully submitted,

RANDALL K. C. KAU.
ANDREW S. MASON.

GORDON HURWITZ BUTOWSKY WEITZEN SHALOV & WEIN,
New York, NY, May 8, 1985.

JOSEPH K. DOWLEY, Esq.,
Chief Counsel, Committee on Ways and Means, House of Representatives, Longworth House Office Building, Washington, DC.

DEAR MR. DOWLEY: We are writing on behalf of our client, Thomson McKinnon Leasing, Inc. ("TM") to request the opportunity to provide oral testimony in connection with the consideration by the House Ways and Means Committee of Section 102(a)(9)(B) of the Technical Corrections Act of 1985, which would retroactively modify, to the detriment of TM and its clients, the "Wide-Body Exemption" which was contained in Section 31(g)(15)(D) of the Deficit Reduction Act of 1984.

Enclosed herewith for your consideration are copies of a letter and memorandum which were sent to the Honorable Thomas J. Downey on April 19, 1985 and a copy of a letter that was sent to Ms. LaBrenda Stodghill, Legislation Attorney on the Professional Staff of the Joint Committee on Taxation, on May 8, 1985.

If you have any questions or desire further information, do not hesitate to contact us.

Very truly yours,

BRUCE J. WEIN
(on behalf of Thomson McKinnon Leasing, Inc.)

Enclosures.

GORDON HURWITZ BUTOWSKY WEITZEN SHALOV & WEIN,
New York, NY, April 19, 1985.

Hon. THOMAS J. DOWNEY
Rayburn House Office Building,
Washington, DC.

DEAR MR. DOWNEY: We are writing on behalf of a client engaged in the investment banking business to express our objection to the above-referred to proposed legislative amendment (the "Proposed Amendment") that would make a substantive change in the law and apply it retroactively to the detriment of our client and its customers.

The crux of our objection is the definition of a "technical correction". A change in law that merely clarifies congressional intent known at the time of passage of a law can be accurately labeled a technical correction and is appropriately applied retroactively. However, a change in law that reflects a change in congressional intent surfacing after passage of a law is a substantive change of law that cannot be fairly applied retroactively to the detriment of a taxpayer. Under all notions of equity, a substantive change in law should be applied on a prospective basis only.

A memorandum containing a more detailed discussion of the law in this matter is enclosed herewith. However, set forth below is a summary of the facts and technical analysis which demonstrates that the Proposed Amendment is a substantive change in the law and, if enacted, would unfairly and retroactively reduce certain tax benefits that would otherwise be available to our client and its customers.

1. On June 27, 1984, Congress passed the Deficit Reduction Act of 1984 (the "Act") which included new rules (the "New Depreciation Rules") for depreciating property

leased to a foreign person or entity. In general, the New Depreciation Rules provide for less generous depreciation allowances than prior law.

2. The Act provided numerous exemptions from the application of the New Depreciation Rules, including an exemption for certain wide-body commercial aircraft (the "Wide-Body Exemption"). The language of the Wide-Body Exemption clearly applies to any wide-body, four-engine commercial aircraft used by a foreign person or entity which was acquired by such foreign person or entity pursuant to a written binding contract entered into on or before November 1, 1983 so long as that aircraft is placed in service before January 1, 1986. The Committee Report accompanying the enactment of the Act did not contain any suggestion that the clear language of the Wide-Body Exemption did not properly reflect congressional intent.

3. On June 29, 1984, an investment group (the "Investor Group") sponsored by a subsidiary of Thomson McKinnon Leasing, Inc. purchased a Boeing 747 jet aircraft (the "Aircraft") from a subsidiary of Allied Corporation. The Aircraft was under lease to KLM—Royal Dutch Airline ("KLM") for a 12 year term. KLM originally purchased the Aircraft in 1971 and in December, 1983, KLM entered into a sale-leaseback with a subsidiary of Allied Corporation. A critical element of the acquisition by the Investor Group was the assumption that the Aircraft would be exempt from the New Depreciation Rules. The Aircraft clearly satisfied the requirements of the Wide-Body Exemption because KLM Originally purchased the Aircraft in 1971 and has continuously used the Aircraft since that date.

4. Prior to March 28, 1985, members of the Investor Group received relevant information from our client to enable them to file their 1984 federal income tax returns on the basis that the New Depreciation Rules did not apply to the Aircraft. The Investor Group computed its depreciation deductions in accordance with prior law; *i.e.*, the Asset Depreciation Range System utilizing the straight-line method over 12 years and the modified half-year convention, resulting in an average annual depreciation deduction of approximately 8.33% of the Aircraft's purchase price.

5. On March 28, 1985, more than 9 months after passage of the Act, the Technical Corrections Act of 1985 was introduced in the House of Representatives. If the Proposed Amendment contained therein is applied retroactively (as is currently proposed), the Wide-Body Exemption would be unavailable. As a result, the Investor Group would be required to use the New Depreciation Rules which would severely limit its depreciation deductions. The Investor Group would be required to compute its depreciation deductions utilizing the straight-line method over 15 years and the half-year convention, resulting in an average annual depreciation deduction of 6.67% of the Aircraft's purchase price. This would result in a reduction of approximately 20% in the depreciation deductions from the prior law rules.

6. The Technical Corrections Act generally provides that technical changes are to be applied *retroactively;* however, substantive changes are to be applied *prospectively* after March 28, 1985.

7. Although cast in the form of a technical correction, the Proposed Amendment is clearly a substantive change of law. Accordingly, the Proposed Amendment should not apply to an aircraft acquired by a taxpayer before March 28, 1985, the effective date for other substantive changes set forth in the Technical Corrections Act. To do otherwise, particularly in the situation where there has been substantial reliance can result not only in unfairness but also lead to an increased lack of credibility in our income tax system and create disorientation in the marketplace.

We would appreciate an opportunity to meet with you at your earliest convenience to discuss this important matter in further detail.

Very truly yours,

BRUCE J. WEIN.

MEMORANDUM

The Deficit Reduction Act of 1984 (the "Act") included several provisions dealing with the depreciation methods available to U.S. taxpayers who lease property to foreign users. One of those provisions requires the taxpayer leasing property to a foreign person or entity to depreciate the property utilizing the straight-line method over 125% of the lease term and the half-year convention (the "New Depreciation Rules"). Under prior law the taxpayer would be entitled to depreciate the Aircraft over 12 years using the straight-line method and the modified half-year convention.

However, the Act contained many exemptions from the application of the New Depreciation Rules. One of the exemptions to the New Depreciation Rules, referred

to herein as the "Wide-body Exemption", is contained in Section 31(g)(15)(D) [1] of the Act. That section provides, in substance, that the New Depreciation Rules are inapplicable with respect to wide-body four-engine commercial aircraft used by a foreign commercial airline, if such airline entered into a written binding contract to acquire such aircraft at any time on or before November 1, 1983 and if such aircraft is placed in service prior to January 1, 1986.

However, Section 102(a)(9)(B) of H.R. 1800 [2] (the "Proposed Amendment"),[3] which was introduced in the House of Representatives on March 28, 1985, would retroactively modify the Wide-Body Exemption. Under the Proposed Amendment, the Wide-Body Exemption would apply only to *new* aircraft; that is, aircraft which are "originally placed in service" after May 23, 1983 and before January 1, 1986.

We believe that the Proposed Amendment to the Wide-Body Exemption, although cast in the form of a technical correction, constitutes a substantive change in the law. As such, the Proposed Amendment should not apply to aircraft placed in service by the taxpayer before March 28, 1985, the effective date for other substantive changes currently proposed.

If the Proposed Amendment is adopted and is applied retroactively, our client and presumably others will be severely prejudiced.

On June 29, 1984 (the "Purchase Date"), the date of purchase of the Aircraft, the clear language of the Act provided that the Aircraft would not be subject to the New Depreciation Rules and our client reasonably believed that depreciation deductions with respect to the Aircraft could be computed in accordance with prior law; *i.e.*, the Asset Depreciation Range System utilizing the straight-line method over 12 years and the modified half-year convention. If the Proposed Revision is applied retroactively, the Aircraft will be subject to the New Depreciation Rules and our client will be required to compute its depreciation deductions utilizing the straight-line method over 15 years and the half-year convention, resulting in an average annual reduction in depreciation deductions of approximately 20%.

Not only does the language of the Wide-Body Exemption clearly apply to the Aircraft, but there is absolutely nothing in the Committee Reports accompanying the enactment of the Act which would indicate that the Wide-Body Exemption was to be limited to new aircraft. The first and only indication that the Wide-Body Exemption might apply only to "new" aircraft is found in the General Explanation of the Revenue Provisions of the Act issued by the Joint Committee on Taxation in January 1985, more than six months after the Purchase Date.[4] Even this statement is far from clear since it doesn't limit the application to new aircraft. In any event, the statement should be given little weight since the Internal Revenue Service has announced that statements of the Joint Committee on Taxation are not considered "authority" for purposes of avoiding the "10% substantial understatement penalty" under Section 6661 of the Code.[5]

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[1] Section 31(g)(15)(D) of the Act reads as follows:

Certain Aircraft. The amendments made by this section shall not apply with respect to any wide-body, four engine, commercial aircraft used by a foreign person or entity if—

(i) on or before November 1, 1983, the foreign person or entity entered into a written binding contract to acquire such aircraft, and

(ii) such aircraft is placed in service before January 1, 1986.

[2] The "Technical Corrections Act of 1985." In addition, an identical provision is contained in S. 814.

[3] The Proposed Amendment would revise clause (ii) of the Wide-Body Exception as follows:

"(ii) such aircraft is originally placed in service by such foreign person or entity (or its successor in interest under the contract) after May 23, 1983, and before January 1, 1986."

[4] The General Explanation provides as follows: "Under a special rule for wide-body, four-engine, commercial aircraft, the Act does not apply to aircraft leased to a foreign person or entity if the foreign person or entity entered into a written binding contract to acquire the aircraft on or before November 1, 1983. This rule applies only to aircraft placed in service prior to January 1, 1986. This rule was intended to apply to new aircraft (i.e., aircraft placed in service after May 23, 1983)."

[5] Section 6661 of the Code provides for a "10% substantial understatement penalty" and final Treasury Regulations issued thereunder provide that "General Explanations" prepared by the staff of the Joint Committee on Taxation do not constitute "authority" for purposes of avoiding such penalty. Since the "General Explanations" do not constitute "authority" for purposes of avoiding the "10% substantial understatement penalty", it would be inequitable to treat pronouncements of the Joint Committee on Taxation as authority for other purposes including determining congressional intent in matters adverse to the taxpayer. As a result, taxpayers should not be charged with actual knowledge of the Proposed Amendment until March 28, 1985, the date on which the Technical Corrections Act was introduced in the House of Representatives. Fairness obviously dictates a *prospective* effective date of March 28, 1985 for the Proposed Amendment.

GORDON HURWITZ BUTOWSKY WEITZEN SHALOV & WEIN,
New York, NY, May 8, 1985.

MS. LABRENDA STODGHILL,
Legislation Attorney, Joint Committee on Taxation, Longworth House Office Building, Washington, DC.

DEAR MS. STODGHILL: As a follow-up to our telephone conversation of Friday, April 26, 1985 concerning the letter sent to the Honorable Thomas J. Downey on behalf of our client Thomson McKinnon Leasing, Inc., we have given some additional thought to the concerns you expressed with respect to the effect on revenues of changing the retroactive effective date of Section 102(a)(9)(B) of the Technical Corrections Act of 1985 (the "Proposed Amendment"). The Proposed Amendment would modify the "Wide-Body Exemption" contained in Section 31(g)(15)(D) of the Deficit Reduction Act of 1984 (the "Act").

As we indicated to you in our telephone conversation, our client did not have any knowledge or reason to believe that the application of the Wide-Body Exemption was intended to be limited to new aircraft. Further, as we pointed out, the language of the exemption for binding contracts found in Section 31(g)(15)(C) (the "Binding Contract Exemption"), the section immediately prior to the Wide-Body Exemption, clearly states that property which has previously been used by a foreign person or entity could not qualify for the Binding Contract Exemption. By comparison, the Wide-Body Exemption does not contain any such limiting language. Accordingly, it was logical for our client to assume that if the Wide-Body Exemption was not intended to apply in the situation where there had been previous use of the aircraft by the foreign user, then the Wide-Body Exemption would have included a restriction on previous use similar to the restriction contained in the Binding Contract Exemption. The General Explanation of the Revenue Provisions of the Act, dated December 31, 1984 and available in early January, 1985, contained the first indication that the statutory language of the Wide-Body Exemption did not reflect your intent.

One suggestion to achieve the desired objectives of fairness to our client and minimization of revenue loss is to exempt from the application of the Proposed Amendment any aircraft that was acquired and placed in service by a taxpayer after June 23, 1984, the date of failing of the Conference Report, and before December 31, 1984, the date of issuance of the General Explanation. As we also pointed out in our telephone conversation, we have no interest in having the exception to the Proposed Amendment apply to any aircraft other than our client's aircraft. Accordingly, if you have any suggestions as to a more restrictive effective date than the one we suggested, we would be happy to discuss it with you.

Thanking you for your consideration in this matter.

Very truly yours,

BRUCE J. WEIN.

STATEMENT OF ARTHUR M. LUBY, GENERAL COUNSEL FOR TRANSPORT WORKERS UNION OF AMERICA AND TRANSPORT WORKERS UNION, LOCAL 525

Mr. Chairman, I am Arthur M. Luby, General Counsel for the Transport Workers Union of America. At the outset, TWU appreciates the opportunity to submit its written testimony in support of the addition of what has been introduced by Mr. Stark as HR 528 to HR 1800—the pending legislation to make technical corrections to the Tax Reform Act of 1984. The comments also represent the views of the other AFL-CIO unions on the property, the International Association of Machinists, AFL-CIO, and the International Union of Operating Engineers, AFL-CIO. I would add that we fully support and concur in the testimony submitted by Mr. Russell Barnes of Pan Am World Services on May 16, 1985.

As indicated above, the proposal we support has been introduced by Mr. Stark as HR 528. It has substantial bipartisan support in the House, including the support from members of this Committee.

The proposal is narrowly designed to remedy an unintended consequence of the "line of business" limitation in the 1984 Act. This restriction prevents employees in corporations with affiliates or subsidiaries from receiving no-additional cost fringe benefits—such as flight benefits—if they are not employed in the "line of business" in which the service is provided. Based on this provision, Pan American Airways was constrained to deprive Pan American World Services employees and retirees of flight privileges which they had enjoyed and counted on for many years.

The injustice of this is obvious. The majority of World Services employees are former Pan Am employees doing precisely the same work for World Services that they had done for Pan Am for many years. Indeed, a substantial number of the

TWU represented World Services employees are actually Pan Am employees on long term detail. These employees accepted their assignments with the understanding that their flight privileges would be retained. This is even more true of World Services retirees, who built up flight privileges while employed by Pan Am and have now been divested of them simply because they spent the last few years of their careers with the World Services subsidiary.

Moreover, collective bargaining at World Services has been deeply influenced by the existence and contemplation of flight benefits. World Services employees supply services to the United States government, primarily in the air and aerospace industry. They are involved in activities as diverse as preparation and maintenance of the space shuttle to the formulation and upkeep at guided missile systems. The availability of these benefits has obviously moderated the wage and benefit needs of these employees and, in the end, lessened the government's contract cost. Of equal significance, the provision of flight benefits has allowed the World Services and the United States to maintain a stable workforce of qualified personnel to perform these crucial activities. This is obviously helpful to the United States in maintaining defense preparedness.

We must emphasize that the proposal we advocate is very narrow and designed to protect only employees hired on or before September 12, 1984. Those employees hired afterwords are, presumably, on notice of the restriction on benefits and can make career decisions accordingly. Under such circumstances, the flight benefits program on World Services will be self limiting and be phased out eventually.

Mr. Chairman, TWU, IAM, and the IUOE strongly urge inclusion of this narrow provision in the Technical Corrections Act of 1985.

STATEMENT OF PAUL C. VANCE, STANFORD, CT

My name is Paul C. Vance. I am a partner in the law firm of Cummings & Lockwood, Ten Stamford Forum, Stamford, Connecticut 06904. My telephone number is (203) 327-1700. I appreciate this opportunity to discuss the provisions of Section 109(b) of H.R. 1800 with specific emphasis on the effective date provision of such section. H.R. 1800 was introduced in the House of Representatives on March 28, 1985. Section 109(b) of H.R. 1800 proposes to amend Section 168(f)(10) of the Internal Revenue Code of 1954, as amended (the "Code").

Section 109(b)(2) would amend Section 168(f)(10) by adding a new sentence at the end of Section 168(f)(10)(B) to read as follows:

"Clause (i) shall not apply in the case of the termination of a partnership under Section 708(b)(1)(B)."

Section 109(b)(3) provides as follows:

"Effective date: The amendments made by this subsection shall apply to property placed in service by the transferee after March 28, 1985 in taxable years ending after such date."

My comments on Section 109(b) are addressed solely to its effective date and not to its substantive aspects.

I represent a client who negotiated the purchase of an 85% interest in a partnership which owns a substantial real estate asset. (The purchase of an 85% interest in a partnership will result in a termination of the partnership under Section 708 of the Code.) Final negotiations commenced in November, 1984 and led to the signing of a definitive purchase agreement on February 14, 1985. On March 29, 1985, and without any knowledge of the provisions of Section 109(b), my client assigned its rights under the contract to a limited partnership controlled by the client, and this assignee limited partnership closed the transaction and purchased the interest on March 29, 1985.

In negotiating this transaction, my client assumed that the current provisions of Section 168(f)(10) would control with respect to cost recovery allowances, and that he would be entitled to cost recovery deductions on the schedule then in use by the existing partnership to the extent of its then adjusted basis. If the effective date provision of Section 109(b)(3) is enacted as proposed, my client would be denied this treatment and would be faced with a substantial reduction in cost recovery allowances.

I suggest that this effective date provision would result in an unintended hardship on my client, and on other taxpayers in a similar position, since he had no way of knowing that this provision would be amended at the time that he negotiated, contracted and closed this transaction.

The Technical Corrections Act is complicated and extensive. Most of the provisions of the Act have not been extensively reviewed or analyzed in the trade litera-

ture. In addition, many of the items that have been addressed in H.R. 1800 were not the subject of discussion prior to the time that the actual legislation was introduced. In light of these factors, I believe it would be appropriate to consider having the effective date for this provision be the date of enactment of the Technical Corrections Act.

In the alternative, in order to alleviate the specific hardship caused to my client and others similarly situated, while still maintaining the integrity of Section 109(b), I suggest that an effective date be provided that is similar to that provided for in P.L. 98-368, Section 111(g)[f]. Thus, under this alternative Section 109(b) would be applicable generally to transactions resulting in a Section 708 termination which occurred after March 28, 1985, with the exception that the amendment made by Section 109(b) would not apply to Section 708 terminations occurring prior to January 1, 1987, if the taxpayer or a qualified person entered into a binding contract on or prior to March 28, 1985 to acquire partnership interests which results in a Section 708 termination after March 28, 1985.

For purposes of the above exception, the term "qualified person" would mean any person who transfers his rights in such a contract to the taxpayer, but only if the partnership interests are not acquired by the qualified person before such rights are transferred to the taxpayer.

I appreciate the opportunity to submit these comments and will be happy to respond to any questions or inquiries you may have or to provide any further information.

STATEMENT OF JOE D. HEUSI, PRESIDENT, THE VARIABLE ANNUITY LIFE INSURANCE CO.

The Variable Annuity Life Insurance Company ("Valic"), headquartered in Houston, Texas, is one of the country's largest issuers of annuity contracts purchased under section 403(b) of the Internal Revenue Code. We currently have more than 300,000 section 403(b) policyholders, the great majority of which are teachers and other employees of public school systems. Our contracts are specifically designed to satisfy the requirements of section 403(b), as well as to meet the needs of our policyholders.

Section 152(a)(3) of the Technical Corrections Bill of 1985 (H.R. 1800) would establish new distribution requirements for annuity contracts purchased under section 403(b) by making the principles of Code section 401(a)(9) (relating to qualified plans) applicable to contributions made under section 403(b) contracts after the date of enactment of the technical corrections bill. We urge the Committee to delete this provision from the bill for the following reasons:

1. Section 152(a)(3) would impose new substantive requirements on section 403(b) annuity contracts; these requirements are manifestly not in the nature of technical corrections to the Tax Reform Act of 1984.

2. Enactment of section 152(a)(3) is not necessary to carry out the intent of the 1984 Act or to further any important policy objective.

3. Enactment of section 152(a)(3) would place unwarranted administrative burdens on companies issuing section 403(b) contracts and cause unnecessary confusion among policyholders.

BACKGROUND

Pursuant to regulations and IRS rulings, it has long been established that the benefits payable under a section 403(b) contract must be for the primary benefit of the participant. In compliance with this requirement, our contracts (as well as those of other companies) require that benefits must commence no later than when the participant attains age 75, and benefits must be paid over a schedule which assures that more than 50 percent of the actuarial present value of benefits is paid to the participant.

The Tax Reform Act of 1984 enacted Code section 72(s), which prescribes post-death distribution requirements that must be set forth in all annuity contracts issued on or after January 19, 1985. Following the 1984 Act, we and other companies revised all of our section 403(b) contract forms to comply with section 72(s), and the revised contract forms were filed with and approved by insurance departments in 50 states and the District of Columbia.

The 1984 Act also changed the distribution rules applicable to qualified plans by amending Code section 401(a)(9); this change represented a *liberalization* of the qualified plan distribution rules that had been imposed by the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"). It is perfectly clear that the require-

ments set forth in section 401(a)(9) do not apply to section 403(b) contracts, and the legislative history of the 1984 Act provides no indication that such an extension of section 401(a)(9) was thought necessary or even contemplated.

REASONS FOR DELETION OF SECTION 152(a)(3)

1. *Section 152(a)(3) is not a technical correction.*—Technical corrections legislation is intended to correct mistakes and clarify unnecessary ambiguities in recently-enacted legislation, not to impose new substantive rules. The Chairman has specifically admonished private interests not to seek substantive changes under H.R. 1800. The integrity of the bill as a technical corrections measure requires that the principle of "mere technical corrections" be consistently followed.

We have heard no suggestion or argument that section 152(a)(3) is a mere technical correction. By making the qualified plan distribution requirements applicable to section 403(b) contracts, section 152(a)(3) would plainly extend section 401(a)(9) beyond its current scope and, just as plainly, restrict the scope of section 72(s). The substantive nature of section 152(a)(3) is confirmed by the fact that the *same* proposal has been made in the Treasury Department's proposals for fundamental tax reform, which were released on November 27, 1984.

2. *Section 152(a)(3) is not necessary.*—We recognize that there may be circumstances under which an amendment of truly substantive effect is appropriately made under a technical corrections bill, as for example, if Congress was unaware of the ramifications of a new provision at the time of enactment, or if a provision as enacted would undermine important policy objectives. Section 152(a)(3) falls in neither category and cannot otherwise be described as a necessary or important change.

The existing distribution rules applicable to section 403(b) contracts have approximately the same effect as the rules set forth in section 401(a)(9). The post-death rules of section 72(s) limit the deferral of benefits in almost exactly the same way as the post-death rules of section 401(a)(9). Further, the pre-death benefit schedules permitted under current law would generally be permitted under section 401(a)(9). The main difference between section 401(a)(9) and current rules applicable to section 403(b) contracts is that pre-death distributions would normally have to commence on April 1 of the year following the policyholder's attainment of age 70½, whereas section 403(b) contracts now require benefits to commence at age 75. Cutting back from age 75 to April 1 of the year following attainment of age 70½ cannot be regarded as such an important difference as to necessitate a change at this time.

The establishment of uniform distribution rules is not an end in itself. The current law rules applicable to section 403(b) contracts, though differing somewhat from the precise rules of section 401(a)(9), are perfectly adequate to carry out the policy objectives reflected in that provision. Moreover, the current rules have the advantage of being in place and widely understood. In any event, there is no abuse or loophole that must be eliminated under an expanded concept of technical corrections.

3. *Section 152(a)(3) would impose unwarranted burdens on companies and policyholders.*—Although the changes required under section 152(a)(3) would not be great, contracts would unquestionably have to be changed. Having just completed this process to comply with the requirements of section 72(s), we and other companies would immediately have to amend our contracts a second time if section 152(a)(3) were enacted. Since the mandate of section 152(a)(3) is not entirely clear,[1] a third set of contractual amendments might be needed upon the issuance of regulations. Moreover, if further changes were enacted as part of tax reform legislation, as has been proposed, still another set of contractual amendments would be required. It is impossible to implement new requirements in an orderly manner when such requirements are repeatedly changed in this manner.

More is involved in changing the terms of insurance contracts than simply changing the words on documents and having those changes approved by state regulators. Administrative and data processing systems must be established to assure that contractual terms are carried out, the sales force must be educated as to the nature and import of the changes in order to inform prospective policyholders, and, if neces-

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[1] Under proposed section 403(b)(10) of the Code, "requirements similar to the requirements of section 401(a)(9)" must be met. Under section 401(a)(9), pre-death distributions must commence no later than April 1 of the year following the year in which the participant attains age 70½ or retires, whichever is later. No explanation has been provided whether a section 403(b) participant who retires after age 70½ would be permitted to delay the commencement of benefits under proposed section 403(b)(10) of the Code.

sary, existing policyholders must be notified. Such changes, especially those requiring the establishment of new systems, can entail very substantial expense. A change that may appear relatively small from a substantive standpoint can nonetheless pose significant administrative burdens.

Section 152(a)(3) would create especially onerous administrative burdens if enacted in its present form. As presently drafted, the bill would make the new distribution requirements applicable to contributions made after the date of enactment under *existing* contracts. This means that companies would have to amend existing contracts and then maintain two sets of accounts for each active policyholder, one applicable to contributions made before enactment of the bill, and the other applicable to contributions made after enactment of the bill. Such double bookkeeping would entail very substantial cost. In our case, for example, we would have to establish and track an additional 300,000 accounts for existing policyholders if section 152(a)(3) were made applicable to existing contracts. Moreover, we have no idea how the distribution requirements of current law and those proposed under section 152(a)(3) could *both* be applied to a single stream of benefits payable under a single contract. Even assuming that guidance were provided on how the different rules would interrelate, it would be virtually impossible to explain that interrelationship to policyholders in an intelligible manner.

At the very least, therefore, it is essential that any change in the distribution rules be limited to newly-issued contracts. In order to provide an orderly transitional period, companies should have at least six months to revise their contract forms and establish new systems before new contracts are required to reflect such changes.

The central point remains, however, that there is no reason to change the law at this time: this is not a technical corrections issue; the rules of current law are in place and working effectively; and there is simply no cause to disrupt current practices to achieve a marginal change.

STATEMENT OF DANIEL W. WATERS, CHAIRMAN, MANAGEMENT COMMITTEE, WHITE PINE POWER PROJECT

Mr. Chairman, I would like to take the opportunity to raise an issue of primary concern to a number of California and Nevada public entities that stand to lose the benefits of a new coal-fired power plant if the Technical Corrections Act of 1985 is enacted as currently drafted. As presently proposed, the Technical Corrections Act could have a substantial adverse impact on the White Pine Power Project, which is now in its sixth year of planning and development.

The White Pine Power Project will be built in White Pine County, Nevada, a political subdivision of the State of Nevada with authority to finance projects for the generation and transmission of electricity under the County Economic Development Revenue Bond Law. As a political subdivision, White Pine County has issued, and proposes to issue, tax-exempt obligations to finance the White Pine Power Project.

In 1980, six California municipally owned utilities (the Department of Water and Power of The City of Los Angeles, and the California cities of Anaheim, Burbank, Glendale, Pasadena and Riverside), two Nevada investor-owned utilities (Nevada Power Company and Sierra Pacific Power Company), three Nevada political subdivisions (Boulder City, Nevada, Lincoln County Power District No. 1 and Overton Power District No. 5) and three Nevada rural electric cooperatives (Mt. Wheeler Power, Inc., Valley Electric Association, Inc. and Wells Rural Electric Company), entered into agreements to undertake the study and development of the White Pine Power Project. This proposed coal-fired 1,500 MW electric generating station would be located within White Pine County and built at a total capital cost of approximately $2.5 billion (1983 dollars). It is estimated that the Project would be in service in the early 1990's.

Most importantly to White Pine County, the White Pine Power Project will provide to it and the State of Nevada significant benefits in increased employment, economic activity and local tax revenues. Payroll during the construction of the generating facilities is estimated to exceed $57 million (1983 dollars) during the year of peak activity, and the operating payroll is estimated to exceed $13 million per year (1983 dollars). The Project will provide significant employment during both the construction and operation phases. Estimated local direct tax revenues from the generating facilities of the Project alone exceed $400 million (1983 dollars) over the life of the facilities.

Under the 1980 agreements, White Pine County is to own 81.333% of the Project, Nevada Power Company is to own 13.334% and Sierra Pacific Power Company is to

own the remaining 5.333%. Consistent with the existing rules on industrial development bonds which exclude certain small participants from the calculation, the privately-owned utilities have an interest in White Pine County's share not exceeding 25%. The participation and financing arrangements for the Project were structured in 1980 to comply in all respects with the requirements under the Internal Revenue Code, to permit tax-exempt financing by White Pine County.

In 1980 and 1984, White Pine County issued tax-exempt notes in the aggregate amount of approximately $17 million to finance development and related costs of the White Pine Power Project on behalf of all the participants. Such notes are payable from, and secured by, payments to be made by such participants under project development agreements. As of March 31, 1985, in excess of $21,120,000 had been expended on development and related costs of the White Pine Power Project.

Upon successful completion of the study and development phase, the participants plan for White Pine County to issue tax-exempt long-term bonds to finance construction of the White Pine Power Project. The bonds will be payable from, and secured by, payments to be made by the participants under power sales contracts. In consideration of these payments, the participants will obtain entitlements to electric capacity and energy of the White Pine Power Project.

Under the Technical Corrections Act of 1985, however, it appears that White Pine County will be unable to issue tax-exempt bonds to finance the construction of the White Pine Power Project because the arrangements concerning the privately-owned participants' payment obligations may be treated, under the Technical Corrections Act, as making White Pine County's bonds "consumer loan bonds."

As a result of the Technical Corrections Act, the two investor-owned utilities in the Project would be precluded from participating under the present contractual arrangements and timetable. To impose new financing conditions and a new ownership/participation structure would be a potentially lethal blow to the Project. Further, if the Project were to be restructured, and survived, it could only do so after previously unforeseen and unnecessary expense and delay.

The 1984 Tax Act added Section 103(o) to the Code, providing that interest on obligations would not be tax-exempt if they are "consumer loan bonds." Section 103(o) of the Code provides that a bond is a taxable consumer loan bond if five percent (5%) or more of the proceeds are reasonably expected to be used, directly or indirectly, to make loans to non-exempt persons. Non-exempt persons include rural electric cooperatives and investor-owned utilities such as those involved in the White Pine Power Project. Thus, an obligation of White Pine County would be a taxable "consumer loan bond" if 5% or more of the proceeds are reasonably expected to be used directly or indirectly to make loans to non-exempt persons such as the privately-owned participants. As indicated, the participation shares of the privately-owned participants in the White Pine Power Project will exceed 5%.

There is no definition of the term "loan" in the 1984 Tax Act or any of the related legislative history. Although the law in this area is unclear, it is possible that the Internal Revenue Service would construe the proposed power sales contracts between White Pine County and the privately-owned participants as indirect loans for federal income tax purposes.

Under current law, including the 1984 Tax Act, the consumer loan bond provisions do not apply to the White Pine Power Project. A transitional rule contained in 1984 Tax Act Section 631(c)(3) provides that the amendments made by the 1984 Tax Act did not apply to obligations with respect to facilities "with respect to which a binding contract to incur significant expenditures was entered into before October 19, 1983." Because of the contractual arrangements previously entered into by the participants with respect to the White Pine Power Project, this transitional rule made the consumer loan bonds provisions inapplicable to the White Pine Power Project.

The problem arises because Section 169 of the Technical Corrections Act would revise the transitional rule set forth in Section 631(c)(3) of the 1984 Tax Act so that the consumer loan bonds provisions of Section 103(o) of the Code would apply to the financing of the White Pine Power Project. As a result, if the arrangements with the privately-owned participants were treated as loans for tax purposes, interest on bonds issued by White Pine County to finance the White Pine Power Project would not be tax-exempt.

Attached to the written text of my remarks is a suggested revision to the Technical Corrections Act which would (by specific reference to the borrowing made by White Pine County on November 12, 1980) continue the exclusion of obligations issued by White Pine County for the White Pine Power Project from the applicability of the consumer loan bonds provisions.

The following would be added to Section 170 of The Technical Corrections Act of 1985:

SECTION 170. AMENDMENTS RELATED TO SECTION 632 OF THE ACT.

At the end of section 632 of the Tax Reform Act of 1984, a new subsection shall be added to read as follows—

"(h) CERTAIN OBLIGATIONS NOT TREATED AS PRIVATE LOAN BONDS.—Obligations (including refunding obligations) shall not be subject to Section 103(o) of the Internal Revenue Code of 1954 if—

(A) such obligations were issued with respect to any facility, and

(B) any obligation was issued on November 12, 1980 in the principal amount of $14,994,000 for the purpose of financing the development, study, or related costs incurred with respect to such facility or any facility related to such facility."

STATEMENT OF HON. BARBARA F. VUCANOVICH, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEVADA

Mr. Chairman, White Pine County is an economically distressed county in my District. It became so when it lost its principal economic activity, copper mining and smelting. To alleviate this distress, the Nevada legislature in 1979, authorized the White Pine Power Project, a 1500 megawatt coal-fueled electric generation facility, pursuant to Nevada's County Economic Development Revenue Bond law. The project will bring electric power to rural Nevada and to metropolitan regions of Nevada and California. It is to be financed by tax exempt revenue bonds.

The project will provide 2,600 direct and 554 support jobs during its four to six year construction phase and 530 direct and 212 support jobs during its 35 year post-construction life. (The County's population is barely 9,000.) The project will also provide payments in lieu of tax to the State of Nevada and its counties of $448,000,000 in 1983 dollars over the project life.

The Technical Corrections Act of 1985 provides that the "grandfather" rule (Section 631(c)(3) of the Tax Reform Act of 1984) will not apply to Section 103(o) of the Internal Revenue Code. This legislation would cause the loss of the tax exempt feature of the bonds of the White Pine Power Project issued after July 18, 1984, because a "significant portion," i.e., 5 percent or more, of the bond proceeds could be deemed directly or indirectly "loan" to non-exempt persons. (Nevada Power Company in southern Nevada and the Sierra Pacific Power Company and Mt. Wheeler Power in northern Nevada have reserved rights in the aggregate to purchase 25 percent of the capacity of the project.) Project bond counsel advise me that they could not give an unqualified opinion that the project's financing arrangements would not constitute "indirect loans." Without tax exempt financing the project more than likely will not go forward. Thus, denial of tax exempt financing to it will not produce any federal revenue.

This project has been in the planning stage since 1979 and in excess of $20,000,000 has been expended or committed for expenditures to finance the development and study costs associated with its ultimate construction. These funds have been used or committed to conduct extensive feasibility and environmental impact studies to determine the feasibility of the project itself, satisfy the mandate of the National Environmental Protection Act and obtain the water, air quality and right-of-way permits required for the project. All this was done in conformity with and good faith reliance upon existing federal laws.

I urge that this project be "grandfathered," that is, that its obligations not be treated as private loan bonds and not be made subject to section 103(o) of the Internal Revenue Code. I think fairness requires this.

Thank you for your consideration of this urgent request.

STATEMENT OF WESTERN-SOUTHERN LIFE, CINCINNATI, OH

THE WESTERN-SOUTHERN PROBLEM

1. In 1984 Congress altered the tax treatment of mutual life insurance companies by imposing in part a new "add-on" tax on "equity". (Title II, Section 809(i), Deficit Reduction Act of 1984). "Equity" under federal tax law is net worth, plus certain reserves, with adjustments.

2. Congress included a "high surplus relief" 5-year transitional rule to avoid an excessively burdensome tax increase on mutual companies with a higher than in-

dustry average surplus, because the 1984 Act changed the 1959 Act rules under which mutual company managements had made accounting judgments.

3. Western-Southern (Cincinnati, Ohio) has surplus higher than the industry average because its management prudently made a good faith business judgment based on the 1959 Act to maintain high additional surplus funds to protect its policyholders (largely blue collar, working class people) against claims exceeding minimal state law reserve requirements.

In recent years, several insurance companies and other financial institutions have failed to meet unforseen or catastrophic disaster claims for want of adequate surplus funds. This fact motivated Western-Southern to increase surplus above the industry average in order to protect its policyholders.

4. In drafting the 1984 Act, all participants (members of Congress, staff, industry) who calculated ratios and estimates understood the term "all assets" [1] as used in Section 809(i), to include *only* the excess of "equity" over net worth (stock carrying value) of a stock subsidiary of a mutual parent. This interpretation met the intention of Congress i.e., "high surplus relief" over the 5 year transitional period.

5. However, this intent of Congress was significantly thwarted in the final hectic hours of the conference on House and Senate versions of the 1984 Act, when, without consideration by the conferees or the interested parties, the language of Section 809(i) was changed from:

"For purposes of the preceding sentence, the assets of a company shall include all assets included in this section in its equity base."

to:

"For purposes of the preceding sentence, the assets of a company shall include all assets *taken into account under this section in determining its equity base (after applying the principles of subsection (h)".* (italic supplied)

6. The change of language as underlined substantially reduces the "high surplus relief" intended by Congress by requiring that a mutual parent and its stock subsidiaries be treated as though they were one mutual life insurance company. As a result the "add-on" tax borne by Western-Southern policyholders in 1984 increased from $14 million to $16.6 million—an 18½% increase.

7. Western-Southern policyholders (Cincinnati, Ohio) are the only mutual life insurance company policyholders in America who suffered so great a tax increase ($2.6 million) as a result of this so-called "technical" correction. Indeed, it operates like a constitutionally prohibited bill-of-attainder in that it "legislates" a forfeiture applicable only to Western-Southern and, to a very limited extent, to a couple of other companies.

8. This $2.6 million extra tax burden on Western-Southern was not really intended by Congress, as it operates to penalize unfairly the blue collar policyholders of *only one company.* This unjust result should be corrected in the Technical Corrections Act of 1985 (H.R. 1800 and S. 814) by restoring the agreed upon language of paragraph 5 above.

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[1] "All assets" was intended to mean that tax assets of a mutual parent would be adjusted to *include* "non-admitted" assets (assets not counted in state statutory accounting) and that the "equity" of a stock subsidiary would be *substituted* for the stock carrying value (net worth) of the subsidiary of a mutual parent.

○